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| Set# | Query |
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| L1 | SEGREGATED WITH ACCOUNT |
| L2 | sub adj2 account$3 |
| L3 | segrgat$2 with account$3 |

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| L4 | segregat$2 with account$3 |
| L5 | owner ownership |
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| L7 | organization$2 |
| L8 | enterprise enterprize |
| L9 | nonvoting with stock |
| L10 | ((investment with discretion) with (gains proceeds profit$1)) with share$1 |
| L11 | l9 same l6 same l6 same l4 |
| L12 | ((investment with discretion) SAME (gains proceeds profit$1)) SAME share$1 |

72/9/1 (Item 1 from file: 608)
07128516
Stock-Market Crash Prevented Hershey Founder's Merger Deal in 1929

Jack Sherzer
Patriot-News, Harrisburg, Pa
September 11, 2002
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 1034

**Text:**

By Jack Sherzer, The Patriot-News, Harrisburg, Pa.

Sep. 11--Milton Hershey himself once contemplated a merger of Hershey Foods Corp. and two outside corporations that would have wrested away control of the chocolate company from the Hershey Trust Co., the trustees asserted in a court filing yesterday.

The chocolate magnate's willingness to cede control of Hershey Foods shows he never intended the trustees overseeing the Milton Hershey School to be hampered in their ability to manage its assets, which include the chocolate company.

The Hershey Trust Co.'s filing in Dauphin County Court was the latest response to the state attorney general's office's attempt to block the trustees from selling Hershey Foods. The attorney general's office maintains it should be able to review any sale to ensure no harm would be done to the school or the local community, which it argues is also a beneficiary.

So far, the trustees have been blocked from executing a sale by a temporary restraining order issued last week by Dauphin County Court Judge Warren G. Morgan, an appeal of which is scheduled to be heard tomorrow in Commonwealth Court.

But even as the trust company filed its papers in court, its chief executive said yesterday that no final decision has been made to sell Hershey Foods.

"We haven't decided to sell the company," Richard C. Vowler, president and chief executive officer of the Hershey Trust Co., said in an interview yesterday with The Associated Press. "We don't have any offers in progress."

Vowler said the trust would continue with the process of asking

company executives to seek bids for the nation's largest candymaker. But he insisted that any sale to new owners would "only be after we were absolutely convinced that it was good for the trust and good for the community."

The Hershey Trust Co. is a for-**profit** corporation managing the Hershey trust -- which finances the Milton Hershey School -- and owns a controlling interest in Hershey Foods. The trust company announced in July that it is considering selling Hershey Foods in order to protect the future of the trust, and the school itself.

Trustees say that having 58.6 percent of the trust's $5.7-billion endowment tied up in Hershey Foods is too risky and that the prudent financial move is to diversify or sell off the company and spread the money in more varied investments.

In yesterday's filing, the trustees said that in 1929, Milton Hershey was ready to merge Hershey Foods with the Kraft-Phenix Cheese Corporation and Colgate-Palmolive-Peet Company -- a deal that never went through because the great stock market crash occurred four days after the merger was executed.

"[The deal] would have required the exchange of the **shares** of the Hershey Chocolate Company in the school trust for **shares** in the new company and would not have resulted in the school trust having voting control in the new company, clearly evidences that [Milton Hershey] did not intend to limit his fiduciaries in the exercise of their **discretion** in making trust **investment** decisions," according to the trustees' court filing.

Attorney General Mike Fisher's office has argued that selling Hershey Foods could cause layoffs and destabilize Derry Twp., where the Milton Hershey School for disadvantaged children is located. Though the trustees say they only must consider the school, attorney general's spokesman Sean Connolly said that is a question for the courts.

"That goes to the heart of our argument -- we want the court to review a sale to ensure that the impact of the community is being considered," Connolly said.

"The attorney general clearly has the right to represent the public's interest in charitable trust matters," Connolly said. "That's what we're doing in this case."

"We are fighting on behalf of the Hershey community, a community that would be greatly harmed by a sale of Hershey Foods," he said.

The trustees, however, in yesterday's filing and in previous arguments, say it's unfounded speculation to say a sale would harm the community. They have also said they would require certain safeguards for the community, though they have refused to go into specifics.

Trustees also say that a sale is likely to "significantly increase the value of the school trust" which would in turn directly benefit the school. To tell the trustees that they have a legal duty to consider anything or anyone else besides the school as a beneficiary "turns trust law on its head by creating beneficiaries," yesterday's filing said.

Analysts cite Nestle S.A., PepsiCo, Kraft Foods and Cadbury Schweppes among potential bidders for the candy giant. And since word of the potential sale leaked in early July, Hershey Food **shares** indeed rocketed in value from the high to low $60s per **share** to the high $70s.

The attorney general's action and subsequent court action have cooled some of Wall Street's ardor, but the stock closed yesterday at $73.53 per **share**.

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The Associated Press contributed to this report.



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**Company Names:** Associated Press ; Cadbury Schweppes ; Colgate Palmolive Peet Company ; Hershey Chocolate Company ; Hershey Food ; Hershey Foods Corp ; Hershey Trust Co ; Knight Ridder/Tribune Business News ; Kraft Phenix Cheese Corporation ; Kraft Foods ; Milton Hershey School ; Nestle S A ; Patriot News ; PepsiCo
**Descriptors:** Agriculture/Food
**Ticker Symbols:** HSY; KFT; CL; NSRGY; PEP; CSG

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72/9/2 (Item 2 from file: 268)
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Poland
Zielinski, Wojciech; Rostek-Wawrzyniak, Agnieszka
International Financial Law Review , p 141-146 , Jul 2002 **Document Type:** Periodical; Feature **ISSN:** 0262-6969 **Journal Code:** IFL **Language:** English **Record Type:** Fulltext
**ARTICLE REFERENCE NUMBER:** IFL-2174-17
**Word Count:** 4,417

**Abstract:**

The Polish banking sector is characterized by a long-term move away from state ownership and a general tendency towards consolidation. Underlining the move toward consolidation is the fact that of the 71 banks now operating, the largest 13 account for over 80% of total assets. Moreover, the stability of the sector is underlined by the fact that 2 of the 13 are directly controlled by the Treasury, with the shareholders of the rest being well-established foreign banks enjoying high credit ratings. Hand in hand with long-term privatization and consolidation come efforts to streamline and modernize banking operations, both through legislation and commercial action.

**Text:**

MARKET STRUCTURE AND TRENDS

The Polish banking sector is characterized by a long-term move away from state ownership and a general tendency towards consolidation. In 2001 the three banks directly controlled by the Treasury accounted for 27% of deposits from non-financial customers, 21% of total assets, and just 11% of capital funds, whereas foreign-controlled banks had respective figures of 64% of deposits, 69% of total assets and 80% of capital funds.

Underlining the move toward consolidation is the fact that of the 71 banks now operating, the largest 13 account for over 80% of total assets. Moreover, the stability of the sector is underlined by the fact that two of the 13 are directly controlled by the Treasury, with the shareholders of the rest being wellestablished foreign banks enjoying high credit ratings.

Hand in hand with long-term privatization and consolidation come efforts to streamline and modernize banking operations, both through legislation and commercial action. Bank employee numbers continue to fall in a drive to cut costs, and electronic banking services are developing, with 15 banks now offering such services.

THE MAIN REGULATORY BODIES AND THEIR POWERS

The Polish Central Bank is the supervisory authority charged with regulating banking activity by way of the Banking Supervision Commission (BSC), which derives its powers from the Law on the National Bank of Poland. Its primary duties are:

* granting consents for the establishment of banks, branches or representative offices of foreign banks and consents for execution of voting rights from large blocks of **shares;**

* suspending operations of banks whose balance sheets show insufficient funds to meet obligations;

* suspending the members of a bank's management board, and imposing financial penalties on members of the management board of a bank in cases which include, for example, failure to carry out recommendations of the BSC relating to conduct of activity in violation of law;

* liquidation of banks.

The Securities and Exchange Commission (SEC) is the regulatory body supervising capital markets and the public trading of securities in Poland. The main purpose of the SEC is supervision of fair trade and competition in the public trading of securities and ensuring public access to reliable information concerning the securities market. In general, the duty of the SEC is to undertake all activities necessary to ensure efficient functioning of the capital markets and the protection of investors. The SEC enjoys very broad powers which include consents for the introduction of securities to public trading and for acquisitions of **shares** resulting in breaching the threshold of 25%, 33% or 50% of the voting rights of publicly traded companies. SEC permits are required for the conduct of activity by investment funds and brokerage houses. The SEC also has the right to order securities to be withdrawn from public trading or to impose financial penalties up to PLN500,000 ($125,000) on brokerage houses, issuers and other entities that introduce securities to public trading.

The regulatory body that supervises the activity of insurance companies and pension funds is the Commission for Insurance and Pension Fund Supervision (Insurance Commission). This newly-- established body, born of the merger between the Office for Pension Fund Supervision and the State Office for Insurance Supervision, became operational on Aril 1 2002. The main duty of the Insurance Commission is supervising the activity of insurance companies and pension funds so as to protect the interests of pension fund members and insured persons. The Insurance Commission also gives its opinion on issuing permits for conducting insurance activity, confirms agreements on transfers of insurance portfolios, issues permits for establishing pension funds and issues permits for acquiring and subscribing for **shares** in pension funds.

TYPES OF FINANCIAL INSTITUTIONS, KEY LEGISLATION AND REGULATORY DEVELOPMENTS

Banks

The activities of banks are regulated by the Banking Law Act and Foreign Exchange Law Act. In addition, banks are also obliged to comply with resolutions of the BSC and Ordinances of the Minister of Finance.

A bank is a legal entity, the exclusive object of business of which is:

* receiving cash deposits payable on request or within due time limits and operating the accounts of such deposits;
* operating orner anK accounts;
* granting credits;
* giving and confirming bank guarantees and opening letters of credit;
* issuing bank securities;
* making bank financial settlements;
* issuing, settling and redemption of electronic money.

Moreover, banks may, on the basis of authorization of the President of the National Bank of Poland, perform certain foreign exchange operations and make certain settlements connected therewith. The Law provides for several types of banks: states banks, cooperative banks and commercial banks, with the latter being dealt with in greater detail later in this text.

Investment funds

The activities of investment funds are regulated in the Law on Investment Funds. An investment fund is a legal entity, the exclusive object of business of which is investing money, collected publicly or privately, in securities and other property rights. The only investment purpose of a fund may be the protection of the real value of the fund's assets, obtaining **profits** from investments or increasing the value of the fund's assets, as a result of an increase in the value of investments. The Law provides for several types of investment funds (open-end, specialized open-end, close-end, specialized close-end, mixed), which differ in, for example, the entities that may become participants in the fund, the manner of participation and the **discretion** over **investment**.

Pension funds

The other financial institutions active on the Polish market since January 1 1998 are pension funds. The activities of pension funds are governed by the Law on Organisation and Functioning of Pension Funds. In light of the Law, a pension fund is a legal entity, whose object of business activity is the gathering of money with a view to making investments in order to pay benefits to fund members upon their reaching retirement age.

Insurance companies

Pursuant to the Act on Insurance Activity, insurance companies may conduct their business in the form of a joint-stock company or mutual insurance society. Moreover, insurance business in Poland may be conducted, on the basis of the reciprocity rule, by a foreign insurance company in the form of a main branch.

A bank may be established by three individuals or by a legal entity, whether Polish or foreign. A bank in the form of a joint-stock company may be established only upon gaining a permit from the BSC issued in conjunction with the Ministry of Finance. The minimum **share** capital for a bank is the PLN equivalent of Eur5.000.000

The BSC will grant its consent provided that:

* the founders and persons envisaged for appointment to the management board warrant that they will engage in prudent and stable management of the bank;
* the three-year banking activity plan prepared by the founders indicates that there would appear to be no risk to cash deposits held with the bank;
* a minimum of two prospective management board members have the

education and professional experience necessary for managing a bank and, in the case of citizens of other countries, a confirmed command of the Polish language. The appointment of two members of the management board, including the president, is subject to the consent of the BSC.

The BSC will issue a permit for establishment of the bank within three months of receipt of a complete application.

The bank may start its operations upon receipt of another permit of the BSC, which may be issued if the bank fulfils the criteria for establishment.

The consents of the BSC will cease to have effect if the bank does not commence its activity within one year of receipt of the permit for establishment of the bank.

The Banking Law also enables foreign banks to conduct banking activity in the form of branches or representative offices. However, whereas a branch is entitled to perform banking operations, a representative office may only promote the activity of the parent bank. The establishment of a branch or representative office is subject to a permit of the BSC, which is issued in agreement with the Minister of Finance. The procedure for establishing a bank is applied accordingly to establishment of a representative office or branch of a foreign bank. The appointment of a director and deputy director of a branch is subject to the consent of the BSC issued subsequent to an application from the given foreign bank.

Investment funds

An investment fund may be established by an investment fund society, after obtaining a permit issued by the Securities and Exchange Commission. An investment fund society may be established only as a jointstock company with its registered seat in Poland, and also requires a permit from the Securities and Exchange Commission for establishing and managing investment funds. The minimum **share** capital of a society is PLN3 million ($750,000). If the society manages more than one investment fund, the amount of **share** capital shall be increased by PLN1 million for each subsequent fund.

The investment fund is required to enter into an agreement with the depository for keeping the register of the fund's assets as well as to collect contributions to the fund in the amount set forth in the statue, but not less then PLN4 million ($1 million), and to enter the fund in the register of funds.

The Securities and Exchange Commission shall issue a decision on granting a permit within two months of submission of the application.

Pension funds

The establishment of a pension fund, is similar to the establishment of an investment fund. A pension fund may be established only by a general pension society or employee pension society. A general pension society may be established only as a joint-stock company with a minimum **share** capital of Eur4 million. The **share** capital may be paid up only by way of a cash contribution. A general society needs to draft a statute for the fund, conclude an agreement with the depositary, obtain a permit from the Commission for Insurance and Pension Fund Supervision and enter the fund into the register of funds. The Commission shall issue a decision on the permit within three months from the date of application. The Commission will reject an application if it does not fulfil the requirements set forth in the law, the fund statute does not ensure the safety of the interests of the pension fund members, or that the employees of the fund are not unfit to properly discharge their duties.

Insurance companies

The statute of an insurace company in the form of a joint-stock company is subject to the approval of the Ministry of Finance, as are any major changes thereto. Its **share** capital cannot be lower than the highest minimum guarantee capital required for the insurance classes in which the insurance undertaking conducts activity.

Finally, to commence insurace activity the company must obtain the permit for conducting insurance activity issued by the Ministry of Finance

subsequent to an opinion given by the Commission for Insurance and Pension Fund Supervision.

FINANCIAL SERVICES: ONLINE AND E-BANKING

The growing popularity of the internet has affected the banking sector as well. The Banking Law Act contributed to the growth of e-banking by providing that declarations of intent submitted in connection with banking operations may be expressed by means of electronic carriers of information. The documents may be drawn up by such carriers providing that they are properly created, fixed, stored and secured. It is worth pointing out that the Banking Law does not contain any specific provisions regarding establishment and conduct of operations by internet banks. The latter are usually organized as companies affiliated with already existing banks and act merely as channels of distribution of new services for customers.

Another question often raised is how internet banks can fulfil their obligations arising out of money laundering laws such as the obligations to identify their customers and to report and/or refuse the execution of suspicious transactions. Apart from these regulatory issues, one also faces the question of the validity of agreements entered into over the internet. The Act on Electronic Signature, implementing the EU Electronic Signatures Directive 1999/43/EC, which will enter into force on August 16 2002, is meant to solve this problem. Pursuant to the Electronic Signature Act, a document signed by a safe electronic signature (which is a signature that meets certain additional criteria provided for in the law) shall have equal legal validity with manually signed documents.

Personal data protection is central to e-banking. E-- banking service contracts must meet the legal requirements set forth in the Personal Data Protection Act. This Act provides for general rules on the lawfulness of the processing of personal data defined as virtually any operation on personal data, including assembling, recording, storage, treatment, modification, giving access, and removal of personal data, especially when it is performed by IT systems. According to the Act, the data administrator must (i) obtain the explicit prior consent of the person whose data is to be processed (ii) adopt technical and organizational measures to ensure the security of processed data.

ACQUISITION OF FINANCIAL INSTITUTIONS

Banks

Pursuant to the Banking Law, a person willing to directly or indirectly purchase or acquire a bank's **shares** is required to obtain the permission of the BSC for exercising voting rights from such **shares** if, as a result of the acquisition or purchase, this person's shareholder-meeting vote entitlement would exceed the next predetermined threshold. Thresholds stand at 10%, 20%, 25%, 33%, 50%, 66%, and 75% of votes at the shareholders meeting. Failure to obtain such permission results in the person being authorized to exercise no more than 5% of the votes or such amount as previously authorized.

Exercising votes in violation of law will result in shareholder meeting resolutions being null and void. The Banking Law provides that the BSC may refuse to grant consent to exercise voting rights from banks' **shares** if the influence of a person intending to acquire or purchase **shares** may prove adverse to the prudent and stable management of the bank when assets used for such acquisition are derived from loans, credits or undocumented sources or when the provisions of law in force where the buyer has its registered seat or place of residence prevent the BSC from exercising effective supervision. The bank must be notified if the block of **shares** held by any person gives it a right to exercise more than 5% of votes at the shareholders meeting. Moreover, the BSC must be notified if a person intends to transfer a block **shares** giving the right to exercise more than 10% of votes at the bank's shareholders meeting.

The above-mentioned requirements are also applicable to the purchase or acquisition of bonds convertible into bank **shares**, depository receipts or other securities giving rise to rights or duties to purchase

**shares**.

Investment funds

Pursuant to the Law on Investment Funds the direct or indirect acquisition of or subscription for **shares** in an investment fund society (resulting in the take over of the investment fund), in an amount that results in attaining the threshold levels of 20%, 33% or 50% of the number of votes at the shareholders meeting of the society, is subject to the permission of the SEC. A permit is also required for acquisition of convertible bonds. The acquisition of or subscription for **shares** or bonds without a permit is void. Taking over the management of an investment fund also requires a permit from the SEC.

Pension funds

In light of the Law on Organisation and Operating of Pension Funds, the subscription for **shares** in a general society by existing shareholders requires a notification to the Commission for Insurance and Pension Fund Supervision. However, any acquisition of or subscription for **shares** in a general society by any other person or entity or a subscription by an existing shareholder resulting in exceeding a shareholder meeting vote threshold of 20%, 25%, 33%, 50%, 66%, 75% or 80% or votes requires a prior permit from the Commission for Insurance and Pension Fund Supervision. Any such acquisition of or subscription for **shares** without such as permit is void.

Insurace companies

In the case of insurance companies a permit from the Ministry of Finance is required for purchases or acquisitions attaining the thresholds of 25%, 50% and 75% of votes at the general shareholders' meeting of the company. Exercising votes in violation of the law will result in shareholder meeting resolutions being null and void. The Ministry of Finance is also the permit-- issuing body for mergers between insurance companies. To obtain a permit, insurance companies are obliged to prove that after the merger they will have ai their disposal funds equal to the required solvency margin. It is also admissible to conclude a contract with another insurance company for the transfer of all or some of its insurance policies (portfolio transfer). Such a contract requires prior permission from the Commission for Insurance and Pension Fund Supervision. The Ministry of Finance also has to be notified of an acquisition of **shares** in an amount that results in obtaining more than 10% of votes at the shareholders meeting of the company.

COMPETITION REGULATIONS

Concentrations involving banks are subject to the general merger control rules set forth in the Law on Competition and Consumer, which requires notification of a concentration if the aggregate worldwide turnover of the corporate groups of the merger participants in the last fiscal year exceed C50 million. Apart from mergers as such, any forms of takeover of control, and the creation of joint ventures, the Competition Law also requires notification of acquisitions of 25% or more of votes at the target's general assembly and of cross-directorships. Concentrations involving certain specific types of financial institutions (in particular investment and pension funds) are governed by special rules.

The Competition Law provides for a number of exemptions from the merger control requirement that may be pertinent specifically to the activity of financial institutions. In particular, no notification is required if the concentration consists in a temporary acquisition of or subscription for **shares**lt; or interests by a financial institution with a view to reselling them, provided that the resale of **shares**lt; or interests takes place within one year from the day of acquisition, and that (a) the institution concerned does not exercise the rights in respect of those **shares**lt; or interests, except for the right to dividend, or (b) exercises such rights only with a view to preparing the resale of all or part of the enterprise, its assets or those **shares**lt; or interests. However, undertakings that have availed themselves of this exemption from the merger control requirement, have to

notify the competition authority if they intend to commence exercising the rights attached to such **shares**lt; or interests subscribed for or acquired without prior notification.

Additionally, there are special rules for the calculation of the turnover of banks, insurance companies, investment funds, and brokerage houses for the purposes of establishing whether the quantitative merger control thresholds were met.

BANK SUPERVISION

Banking supervision seeks to continually ensure that bank account deposits are safe and that banks are conducting their activity in compliance with relevant provisions of law. Prudential supervision seeks to safeguard the solvency and liquidity ratios as well as concentration limits of the banks. The BSC has powers to give banks recommendations and general directives on the conduct of banking activity, as well as means of collecting, reviewing and analyzing reports from the banks on a solo and consolidated basis.

The banks are obliged to have in place administration, book-keeping and internal control arrangements in accordance with applicable law.

DISCLOSURE REQUIREMENTS

As indicated above, the competent Polish authorities must be informed in a timely fashion of possible changes with respect to significant changes in shareholding structure (described above) as well as with respect to changes in the management of a bank. The BSC is obliged to refuse consent for appointment of board members with criminal convictions or punished for intentional offences or if fiscal criminal proceedings are being conducted against them. Moreover the BSC may refuse its consent for appointment of such individuals if they do not warrant that they will engage in stable and prudent management of the bank or do not have the necessary education and experience or if they have caused documented property losses in their previous places of work.

WHEN A BANK BECOMES INSOLVENT

As described above, the BSC has an extensive set of instruments for use where the solvency or liquidity of the bank gives cause for concern.

* If a bank incurs a balance sheet loss or there is threat of such a loss, the BSC may indicate a time limit for preparation of recovery programme proceedings;
* If the management board fails to submit a recovery programme or such programme proves ineffective, the BSC may decide to appoint a commissioner-administrator for the bank;
* If the bank's losses exceed half of the bank's own funds or the bank's assets do not suffice to satisfy its obligations, the BSC may decide to suspend the bank's activities and to have it taken over by another bank, to liquidate the bank, or to file a petition for declaration of bankruptcy with the relevant court.

The deposits held in bank accounts are covered by part of the mandatory bank deposit guarantee system. All banks are obliged to contribute mandatory payments to the Bank Guarantee Fund. The Fund guarantees account holders repayment of certain levels of monies if a bank is declared bankrupt. In the case of deposits not exceeding E1,000, the Fund is obliged to pay out 100% of such amounts and for amounts exceeding Eur 1,000 but less than Eur18,000 - 90%.

CAPITAL REQUIREMENTS AND BANK SECRECY

Liquidity and solvency

Pursuant to the Banking Law, a bank is obliged to main liquidity as required by the, type and volume of its activity under the regulatory supervision of the BSC.

Moreover, banks are obliged to maintain a minimum 8% solvency ratio, with this ratio rising to 15% for the first year of a start-up and 12% for the second year of a start-up.

Large exposures

The total sum of a bank's exposure resulting from receivables and off-balance sheet liabilities with respect to one entity or group of

entities connected organizationally or in capital may not exceed (i) 20% of the bank's own funds if any such entity is a dependent or dominant entity to the bank or dependent on a dominant entity of a bank, or (ii) 25% of the bank's own funds in case of other entities.

BANK SECRECY

The Banking Law defines bank secrecy as:

* All information regarding banking operations and persons party to an agreement with a bank subsequent to negotiations, as well as connected with the conclusion of such an agreement and the implementation thereof with the exception of information without which the carrying out of the agreement would be impossible;

* Information regarding persons who are not a party to an agreement with a bank, but who performed operations connected with the conclusion of such contract.

The obligation to preserve bank secrecy relates not only to banks and their employees but also to entities that banks engage to facilitate conduct of their banking operations. Information falling within the scope of bank secrecy may be disclosed to a third party upon prior written consent of the party to an agreement with a bank and, further, such consent must specify exactly the scope of information to be disclosed and the beneficiary of such information. Banking Law provides for certain exceptions in disclosing information covered by bank secrecy, including disclosures to other banks, the BSC, courts, the Police, prosecutors in connection with pending criminal proceedings against account holders and institutions whose role it is to counteract money laundering.

WOJCIECH ZIELINSKI

Salans Law Firm, Warsaw

Wojciech Zielinski is a partner with the law firm of Salans. He is a member of the Financial Institutions Practice Group of the firm and is based in Warsaw. Before joining Salans, Wojciech Zielinski practised as a lawyer in the Office of the Council of Ministers. Mr Zielinski was involved in drafting the early Polish legislation concerning banking, foreign exchange law, and taxes. From 1993 through 1996 he was general counsel to the Polish Investment Bank. At that time, he was responsible for all legal services of the Bank including such issues as lending and tak

ing of security (including real estate), venture capital, mergers and acquisitions, and capital markets. Since June 1996 he has been with the Warsaw office of Salans.

Mr Zielinski has wide experience in a number of areas including banking, privatization, project finance, corporate finance, general lending and taking of security, taxation of foreign multilateral and bilateral institutions, investment funds and major companies investing in Poland.

Mr Zielinski graduated with a master's degree from the Faculty of Law and Administration at Warsaw University in 1986 and was admitted as a legal adviser in Poland in 1991. He speaks Polish and English.

AGNIESZKA ROSTEK-WAWRZYNIAK

Salans Law Firm, Warsaw

Agnieszka Rostek-Wawrzyniak is a senior associate with the law firm of Salans. She is admitted to practice in Poland as a legal adviser. She is a member of the Financial Institutions Practice Group of the firm and is presently based in Warsaw. Before joining the Warsaw office of Salans, she worked for an American law firm based in Warsaw, where she was responsible for developing the banking practice.

Ms Rostek-Wawrzyniak specializes in corporate finance and banking law. She has broad experience in the area of international syndicated loans, commercial banking, and foreign exchange instruments, as well as in the financing of investment ventures, the issuance of bank securities and the selection of security arrangements for various transactions. Agnieszka Rostek-Wawrzyniak worked as an in-house lawyer for a financial institution and she was in charge of legal issues relating to the establishment and organization of a bank, drafting bank regulations, lending procedures, loan documentation, as well as advising on all aspects of banking operations.

Her practice also includes factoring and insurance.

Ms Rostek-Wawrzyniak graduated with a Master's Degree from the Faculty of Law and Administration at Warsaw University, majoring in financial law. She obtained the Certificate of Studies of Oxford and Cambridge Universities on completion of a one-year course on Common Law and the EU law, run by the British Centre for English and European Union Legal Studies at Warsaw University. In 1993, she obtained an MA in Economics at the Warsaw School of Economics, where she graduated from the Foreign Trade Department, specializing in banking and international marketing.



**Classification:** 9176 (CN=Eastern Europe); 4310 (CN=Regulation); 8100 (CN=Financial services industry); 2330 (CN=Acquisitions & mergers)
**Descriptors:** Banking industry; Consolidation; Bank acquisitions & mergers; Industrywide conditions; Regulation of financial institutions
**Geographic Names:** Poland
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07057447
Offshore Institutions Complicate World of Private British Banks

Martin Baker
Sunday Business, London
April 07, 2002
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 968

**Text:**

By Martin Baker, Sunday Business, London

Apr. 7--More is the new imperative for private banking -- more transparency, more aggressive marketing and more competition than ever. One fundamental rivalry is between offshore and onshore banking locations.

Leon Blitz, co-head of private banking in Europe for Investec, argues that the whole offshore industry has changed.

"The events of 11 September have made doing business offshore more difficult and have made people aware of their own mortality. The emphasis has moved from secrecy and discretion to restructuring and organising portfolios and estates into tax-efficient formats to minimise estate duties, and so on, on death."

Catherine Tillotson of the Scorpio Partnership, a financial research consultancy, notes that some mainstream jurisdictions are trading on their respectability against an increasingly attractive fiscal background. "The perceived tax benefits of investing offshore are attractive. But some governments have made it their business to make domestic investment enticing. The Italians are a case in point, where capital **gains** tax has been fixed at 12.5 percent ," she says.

The vast majority of the estimated $27,000 billion private banking market is held offshore, however. And competition is hotting up. Christopher Raggett, a financial services partner at accountants Warr & Co, notes that "the big global banks, like Deutsche and the 'bulge bracket' US banks have expanded into the market for what is nowadays referred to as

'the mass affluent'."

He divides up the industry according to the size of their clients' investable assets. He sees the big global players targeting an estimated 7.2 million individuals with more than $1 million. A $1 million deposit can bring little more than a glorified investment advisory service, he says.

"The bulge bracket banks offer a very different service from outfits with three branches and a 300-year track record in a Swiss canton. Essentially, the choice boils down to personalised investment and tax advice on a global scale from the bigger players and discreet wealth protection and boutique investment advice from the smaller players -- which includes many of the traditional Swiss banks, such as Julius Baer, Vontobel and EFG Private Bank."

The biggest players are the Swiss banks, UBS and CSFB, which require a minimum of Sfl million as a starting point. The Swiss feel they cannot miss out when they look at the aggressive pushes of organisations such as CitiCorp and Merrill Lynch.

An investor with Sfl million will get the equivalent of an early Ford -- any colour they like, as long as it's black. They are unlikely to be offered a tailor-made investment strategy but most banks have general strategies and asset allocation models to cater for differing degrees of risk at such relatively low investment levels.

Banks such as Coutts and the Geneva-based Pictet & Cie specialise in providing investment advice rather than an all-singing, all-dancing trust and discretionary advice service.

With the new transparency has come a more open attitude towards monitoring **investment** performance. When **discretion** was the watchword, it was difficult to compare asset managers. Now performance is important in determining who will be the winners in the new market, according to Niels Jensen, managing director of private client services for Lehman Brothers in Europe.

He says: "The Swiss have a huge advantage over other financial centres because for years and years they have attracted offshore money with no investment restrictions and have been investing in what you might call alternative investment media -- such as hedge funds -- for considerably longer. That's going to be reflected in their investment performances versus private client banks in France, Germany or the UK."

Lehman Brothers adjusts its portfolios for each client: "We use two categories of market-neutral hedge funds. We've been replacing bonds with low-risk, low-return vehicles, with a standard deviation of 4 percent -5 percent and returns at 10 percent -12 percent a year, although one has to let the investment run for a five-year period to have a good chance of getting that.

"The second category of fund has a standard deviation of 8 percent -10 percent and you can get returns of 15 percent -17 percent ."

Despite the desire for market **share**, some banks will not let investors through the door unless they have $10 million. SG Hambros, which positions itself at the higher end of the market, offers a service that is more than purely advisory. One of its key services is fiduciary, essentially amounting to an offshore trust service. The market consensus is that at least UKpound 2 million is needed to justify the expense of setting up a customised investment scheme or offshore asset shelter.

Deutsche Bank is one global player pushing for a **share** of this market. "On the advice of their tax and legal advisers, clients entrust us with the orderly, tax-efficient preservation and protection of their assets for future generations," a spokesman says.

"We work closely with our clients and their advisers to set up structures that meet their needs precisely and which will continue to be administered effectively, professionally and efficiently long into the future. Wherever the client may be based and whichever centre is chosen, they are assured of the highest quality of service, as our business standards are centrally set and uniform throughout all jurisdictions."

The basic fiduciary service includes companies, trusts, limited

partnerships, private investment vehicles, private pension plans, personal employment structures, estate planning, and legal processes for the transfer of wealth, with the object of minimising tax.

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UKpound preceding a numeral refers to the United Kingdom's pound sterling. 

**Company Names:** CitiCorp ; Deutsche Bank ; EFG Private Bank ; Julius Baer ; Knight Ridder/Tribune Business News ; Lehman Brothers ; Merrill Lynch ; Pictet & Cie ; Scorpio Partnership ; Vontobel ; Warr & Co

**Descriptors:** Banking/Economy/Personal Finance/Stocks

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72/9/4 (Item 4 from file: 608)
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Endowment Shock Threatens British Mortgage Repayments

Charlotte Beugge
Daily Mail and the Financial Mail on Sunday, London
January 09, 2002
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 803

**Text:**

By Charlotte Beugge, Daily Mail, London

Jan. 9--Endowment payouts have gone into freefall, provoking fresh fears that homebuyers will not be able to repay their mortgages.

Figures released by Scottish Widows reveal a typical policy maturing today might be worth an incredible UKpound 29,263 less than it was just three years ago.

Based on a benchmark 25-year, UKpound 50-a-month policy, a Scottish Widows policy maturing on February 1 will be worth UKpound 75,004. Yet three years ago, the same policy would have paid UKpound 104,267 -- a fall of more than 28 pc.

Only last autumn, the maturity value of a comparable policy was nearly UKpound 10,000 higher.

Scottish Widows is the first major with-**profits** insurer to declare its results and its experience is likely to be echoed by other insurers. It is terrible news for millions of people who have with-endowment mortgages and are already looking at shortfalls on their repayments.

Scottish Widows is, traditionally, one of the better with-**profits** insurers, and bonus declarations from others could show even bigger falls. The giant Norwich Union, which covers Commercial Union and General Accident policies, is expected to announce its figures soon.

The news comes on the same day as the Financial Services Authority slammed the arcane structure of with-**profits** and claimed that customers are prevented from knowing how their bonuses are calculated thanks to complex policies.

Scottish Widows blames the stock market's bad performance over the past two years for falling payouts. However, the whole idea of with-**profits** is that the peaks and troughs are meant to be smoothed out.

These endowment figures look worse when compared with other forms of investment which don't operate the so-called "smoothing" process. A UKpound 50-a-month investment in the M&G British Opportunities fund -- a middle-of-the-road unit trust investing in a range of company **shares** -- would now be worth UKpound 134,477: nearly UKpound 60,000 more than the Scottish Widows endowment.

The downturn is particularly shown by the maturity values of ten-year savings endowments, again maturing on February 1. A UKpound 50-a- month policy taken out by a 29- year-old man ten years ago will on February 1 be worth UKpound 8,094 -- a return of just UKpound 2,094 on the UKpound 6,000 invested.

And it's not just the maturity values that are falling. With-**profits** are awarded annual bonuses which are falling 20 pc.

Mike Ross, chief executive of Scottish Widows, says: "Over the past few months, people with investments linked to the stock market are likely to have seen the values of these fall dramatically.

"With-**profits** investments smooth out the effect of these falls but cannot defy the laws of gravity, so it is inevitable that adjustments have to be made."

The problem with with-**profits** policies is that most investors do not have know how they work.

The FSA is today addressing these concerns in a paper, Disclosure To Consumers, which is a blueprint for how the FSA wants information on with-**profits** savings plans to be presented in the future.

Research commissioned as part of the paper shows that savers do not understand the risks involved in what are largely **share**-based investments, or the charges they have to pay.

Part of the problem is that the language used is complicated and the actuaries that run these funds have **discretion** over how much **investment** growth they dole out each year and the charges they impose.

The paper points out that some savers may not know that they are gambling not only on the investments in the with-**profits** fund, but also on how well the insurance company as a whole performs.

With-**profits** funds do not say exactly how much they charge for managing savers" money. This, says the FSA, makes it hard for savers to compare prices with other savings plans.

The regulator is looking at whether it needs to change the rules to ensure clear, fair and comparable charges are given.

The FSA also wants it made clear that the bonuses paid on a plan each year are not the same as the returns on a with-**profits** fund over the year. Insurers would then get the chance to explain why this is so.

It should also be made clear, it says, that future bonuses are not certain, and savers should be told which benefits are guaranteed and which are not.

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**Company Names:** Commercial Union ; Daily Mail ; Knight Ridder/Tribune Business News ; M & G British Opportunities ; Norwich Union ; Scottish Widows

**Descriptors:** Banking/Economy/Personal Finance/Stocks
**Ticker Symbols:** SPI; CGNU

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72/9/5 (Item 5 from file: 268)
00431201 226992581
United Arab Emirates: Islamic finance--a UAE legal perspective
Hourani, Husam; Ulama, Abdul Wahid Al
Euromoney , p 201-205 , 2002/2003 **Document Type:** Periodical; Feature **ISSN:** 0014-2433 **Journal Code:** ERM **Language:** English **Record Type:** Fulltext
**ARTICLE REFERENCE NUMBER:** ERM-2219-113
**Word Count:** 3,080

### Abstract:

Almost three decades ago, the concept of Islamic finance was considered wishful thinking. Today, more than 300 Islamic financial institutions are operating worldwide, estimated to be managing funds in the region of US$200bn. The prohibition of usury or interest is clearly the most significant principle of Islamic finance. The United Arab Emirates Federal Law No. 5 of 1985 concerning civil transactions, which was issued with the aim of achieving maximum compliance with the Shari'a, recognises this principle. Thus far, Islamic scholars have approved certain basic types of contracts as being compliant with the principles of Islamic finance, and which may be used by Islamic banks to attract funds and to provide financing in a truly Islamic way.

### Text:

Almost three decades ago, the concept of Islamic finance was considered wishful thinking. Today, more than 300 Islamic financial institutions are operating worldwide, estimated to be managing funds in the region of US$200bn. Their clientele are not confined to citizens of Muslim countries, but are spread over Europe, the US and the Far East. Muslims now have the opportunity to invest their financial resources in accordance with the ethics and philosophy of Islam.

The first thorough studies devoted to the establishment of Islamic financial institutions (referred to hereafter as \Islamic Banks') appeared in the 1940s, Although Muslim-owned banks were established in the 1920s and 1930s, they adopted similar practices to conventional banks. In the 1940s and 1950s, several experiments with small Islamic Banks were undertaken in Malaysia and Pakistan. The first great success was the establishment of an Islamic Bank in the Egyptian village of Mit Ghamr in 1963. Other successes include the establishment of the Inter-Governmental Islamic Development Bank in Jeddah in 1975, and a number of commercial Islamic Banks such as the Dubai Islamic Bank, the Kuwait Finance House and the Bahrain Islamic Bank in the 1970s and 1980s. Commercial banks have also realised the potential of this new field, and a number of major worldwide institutions have grasped Islamic banking as a significant mechanism for more diversified growth.

This article aims to provide a general overview of Islamic finance. It describes the fundamental principles of Islamic finance and the main financing techniques.

PRINCIPLES OF ISLAMIC FINANCE

Background. Islam, the religion of Muslims, is a complete way of life that has a set of goals and values encompassing all aspects of human life including social, economic and political issues. It is not a religion in the limited sense of the word, interested only in man's salvation in the life to come, rather it is a religion that organises life completely. The body of Islamic Law is known as "Shari'a", and the exact literal translation of "Sharia" is "a clear path to be followed and observed".

The Shari'a is not a codified law. It is an abstract form of law capable of adaptation, development and further interpretation. The Shari'a does not prescribe general principles of law, instead, it purports to deal with and cover specific cases or transactions and sets out rules that govern them.

The Shari'a developed through four major Islamic juristic schools (Hanafi, Maliki, Shaft and Hanbali) and is derived from two primary sources, the Quran (the transcription of God's message to the Prophet Mohammed) and Sunna (the living tradition of the Prophet Mohammed), in addition to two dependent sources, namely ijma (consensus) and ijtihad /qiyas (individual reasoning by analogy).

The recent surge of religious conciousness amongst Muslims has provided the drive towards implementing and adopting Islamic principles in financial transactions. In an attempt to purify assets in the eyes of Islam, Muslims are seeking a greater balance between their lives in the modern technological world and their religious faith and beliefs.

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions, is the prohibition of all sources of unjustified enrichment and the prohibition of dealing in transactions that contain excessive risk or speculation. Accordingly, Islamic scholars have deduced from the Shari'a three principles that form the benchmark of Islamic economics; and which distinguish Islamic finance from its conventional counterpart. These are briefly as follows:

The prohibition of interest (Riba). The prohibition of usury or interest (Riba) is clearly the most significant principle of Islamic finance. Riba translates literally from Arabic as "an increase, growth or accretion". In Islam, lending money should not generate unjustified income. As a Shari'a term, it refers to the premium that must be paid by the borrower to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

Riba represents, in the Islamic economic system, a prominent source of unjustified advantage. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since Shari'a does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value.

The United Arab Emirates Federal Law No. 5 of 1985 concerning civil transactions (the \Civil Code'), which was issued with the aim of achieving maximum compliance with the Shari'a, recognises this principle, and states in Article 714: "If the contract of loan provides for a benefit in excess of the essence of the contract otherwise than a guarantee of the rights of the lender, such provision shall be void but the contract shall be valid."

**Profit** and loss sharing (PLS). PLS financing is a form of partnership, where partners **share profits** and losses on the basis of their capital **share** and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that Muslims do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the PLS-financier's **share** in **profit** is his effort and the risk he carries, since his **profit** would have been impossible without the investment. Similarly, if the investment has made a loss, his money would be lost.

Gharrar. Any transaction that involves Gharrar (i.e. uncertainty and speculation) is prohibited. Parties to a contract must have actual knowledge of the "subject matter" of the contract and its implications. An example of an agreement tainted with Gharrar is an agreement to sell goods which have been already lost.

FINANCING TECHNIQUES

Thus far, Islamic scholars have approved certain basic types of contracts as being compliant with the principles of Islamic finance, and which may be used by Islamic banks to attract funds and to provide financing in a truly Islamic way. Before going into the peculiarity of each and every type of contract, there are, in general, four conditions required to effect a valid contract:

* a price that is agreed mutually and not under duress;
* between parties that are sane and have the legal capacity to understand the implications of their actions;
* at the time of contracting, the subject matter of the contract should be in existence and able to be delivered without uncertainty or deception;
* the contract should not be based upon a consideration (for the purposes of this brochure, this is translated as counter-value) that is itself prohibited under the Shari'a (e.g. alcohol, pork products, etc.).

In accordance with these conditions, the United Arab Emirates Civil Code in Article 129 states: "The necessary elements for the malting of a contract are:

(a) that the two parties to the contract should agree upon the essential elements;

(b) the subject matter of the contract must be something which is possible and defined or capable of being defined and permissible to be dealt in; and

(c) there must be a lawful purpose for the obligation arising out of the contract."

The major Islamic contracts are as follows:

Mudaraba (trust financing). Mudaraba is a form of partnership in which one partner provides the capital required for funding a project (Rab-ul-amal),while the other party (known as a Mudarib), manages the investment using his expertise. Although similar to a partnership, it does not require a company to be created, so long as the **profits** can be determined separately. **Profits** arising from the investment are distributed according to a fixed, pre-determined ratio. The loss in a Mudaraba contract is carried by the capitalprovider unless it was due to the negligence, misconduct or violation of the conditions pre-agreed upon by the Mudarib.

In a Mudaraba, the management of the investment is the sole responsibility of the Mudarib, and all assets acquired by him are the sole possession of Rab-ul-aural. However, the Mudaraba contract eventually permits the mudarib to buy out the Rab-ul-amal's investment and become the sole owner of the investment.

Mudaraba may be concluded between the Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee (please note this has a different meaning to the English law concept of trustee) of their funds, and its business-owner clients. In the latter case, the bank pays its depositors all **profits** received out of the investment, after deducting its intermediary fees. It may also be conducted between the bank's depositors as providers of funds and the Islamic Bank as a Mudarib.

Mudaraba can either be restricted or unrestricted. Where unrestricted, depositors authorise the bank to invest their funds at its **discretion**. In the restricted Mudaraba, the depositors specify to the bank the type of **investment** in which their funds should be invested.

The United Arab Emirates Civil Code includes a chapter under the title of "Mudaraba", Article (693) thereof states: "A Mudaraba is a contract

whereby the person owning property puts in the capital, and the Mudarib puts in effort or work, with a view to making a **profit**."

Mosharaka (partnership financing). Mosharaka is often perceived as an old-fashioned financing technique confined in its application to small-scale investments. Although it is substantially similar to the Mudaraba contract (see above), it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment.

**Profits** are **shared** between partners on a pre-agreed ratio, but losses will be **shared** in the exact proportion to the capital invested by each party. This gives an incentive to invest wisely and take an active interest in the investment. Moreover, in Mosharaka, all partners are entitled to participate in the management of the investment, but are not necessarily required to do so. This explains why the **profit**-sharing ratio is left to be mutually agreed upon and may be different from the actual investment in the total capital.

In a typical Mosharaka between a bank and a customer (i.e. partner), at the time of distribution of **profits**, the customer pays the bank its **share** in the **profits** and also a pre-determined portion of his own **profits**, which then reduces the bank's shareholding in the investment. Eventually, the customer becomes the complete and sole owner of the investment.

The United Arab Emirates Civil Code recognises Mosharaka in a general way and states in Article 654 thereof: "A company is a contract whereby two or more persons are bound each to participate in a financial project by providing a **share** of property or work for the exploitation of that project and the division of any **profit** or loss which may arise thereout."

Morabaha (cost-plus financing). Morabaha is the most popular form of Islamic financing techniques. Within a Morabaha contract, the bank agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then re-sells the assets or goods to its client with a mark-up **profit**. The client purchases the goods either against immediate payment or for a deferred payment.

This financing technique is sometimes considered to be akin to conventional, interest-based finance. However, in theory, the mark-up **profit** is quite different in many respects. The mark-up is for the services the bank provides, namely, seeking out, locating and purchasing the required goods at the best price. Furthermore, the mark-up is not related to time since, if the client fails to pay a deferred payment on time, the mark-up does not increase due to delay and remains as pre-agreed. Most importantly, the bank owns the goods between the two sales and hence assumes both the title and the risk of the purchased goods, pending their resale to the client. This risk involves all risks normally contained in trading activities, in addition to the risk of not necessarily making the mark-up **profit**, or if the client does not purchase the goods from the bank and whether he has a justifiable excuse for refusing to do so. However, the Organisation of the Islamic Conference ("OIC") has declared that a customer's promise to purchase the goods in a Morabaha is an ethically binding promise. Accordingly, the OIC Academy has held that the customer is bound to compensate the bank for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods.

The purchase of goods under the Morabaha contract may be funded by the Islamic Bank either from its own funds or from the funds of its depositors. In the latter case, the bank acts as its depositors' agent, retaining its fees from the mark-up **profits**. In such circumstances, the depositors will own the purchased goods during the period pending its resale, and therefore assume its risk.

Article 506 of the United Arab Emirates Civil Code covers Morabaha sales:

1. "A sale may be by way of resale with a **profit**, a loss,

or at cost price if the capital value of the thing sold is known at the time of the contract, and the amount of the **profit** or loss is specified.

2. If it appears that the seller has exaggerated in declaring the amount of the capital value, the purchaser may reduce (the amount) by the amount of the excess.

3. If the capital value of the thing sold is not known when the contract is made, the purchaser may rescind the contract when he learns of it, and the same shall apply if the seller conceals a matter affecting the thing sold or the capital value, and he shall lose his right to elect if the goods are sold or consumed or pass out of his ownership after delivery."

Ijara (Leasing). Ijara is defined as sale of Manfa'a (i.e. sale of right to utilise the goods for a specific period). The Ijara contract is very similar to the conventional lease. Under Islam, leasing began as a trading activity and then much later became a mode of finance. Ijara is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. The jargon accorded to the financier, that is the bank, is "lessor", and to the client, "lessee".

During a pre-determined period, the ownership of the asset remains in the hands of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented. likewise, the lessor assumes the risk of ownership, and in practice seeks to mitigate such risk by insuring the asset in its own name. Under an Ijara contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed interval. This is to ensure that the rental remains in line with prevailing market leasing rates and the residual value of the leased asset.

Article 742 of the United Arab Emirates Civil Code defines the Ijara as: "A hire shall be the conferring by the lessor on the lessee of the right of use intended for the thing hired for a specified period in consideration of an ascertained rent."

Under this contract, the client does not have the option to purchase the asset during or at the end of the lease term since this is considered under the Shari'a to be tainted with uncertainty. Yet, this may be reached under another contract, very similar to Ijara (known as an Ijara wa Atina - hire-purchase) except that there is, at the outset, a commitment from the client to buy the asset at the end of the rental period, at an agreed price, with rental fees previously paid constituting part of the price.

Salam (advance purchase). Salam is defined as forward purchase of specified goods for full forward payment. This contract is regularly used for financing agricultural production.

Article 568 of the United Arab Emirates Civil Code defining Salam states: "A forward sale is for property, the delivery of which is deferred, against a price payable immediately."

Article 569 of the United Arab Emirates Civil Code states its requirements: "The following conditions must be satisfied for a forward sale to be valid:

1. The property must be such as can be specified by description and quantity, and it must normally be available at the time of delivery; and

2. The contract must contain particulars of the nature, type, description and amount of the goods, and the time at which they are to be delivered."

Istisna'a (commissioned manufacture). Istisna'a is a new concept in modern Islamic finance that offers a number of future structuring possibilities for trading and financing. In this contract, one party buys the goods and that the other party undertakes to manufature the goods, according to agreed specifications.

Islamic financial practice holds that the contract is binding on both parties at the outset. Islamic banks frequently use Istisnaa to finance construction and manufacturing projects.

There is no specific article in United Arab Emirates law that expressly refers to and deals with Istisna'a, however, the official

commentary to the United Arab Emirates Civil Code stipulates that the Sharia principles of Istina'a are to apply in the case of construction contracts (Muqawala) as defined in Article (872) thereof, that states: "A muqawala is a contact whereby one of the parties thereto undertakes to make a thing or to perform work in consideration which the other undertakes to provide".

CONCLUSION

Since Islam is the religion of the United Arab Emirates as stated in the United Arab Emirates Constitution, the United Arab Emirates is ideally placed to play a leading role in Islamic finance. In addition, implementing Islamic financial mechanisms are well suited to the legal system as it is always better to be an owner rather than a security holder in any transaction.

Furthermore, the United Arab Emirates Civil Code has a very strong Shari'a foundation which supports the proper regulations of Islamic financial mechanisms. Finally, the judges in the United Arab Emirates come from an Islamic background familiar with Islamic concepts and contracts. This fact will eventually lead to the speedy conclusion of matters as cases will not be required to be referred to experts as frequently as in the past. Accordingly, judgments will become more predictable leading to more certainity in Islamic banking transactions.

By Husam Hourani and Abdul Wahid Al Ulama, Al Tamimi & Company

This article was written by Husam Hourani and Abdul Wahid Al Ulama, Al Tamimi & Company, 29th Floor, Dubai World Trade Centre, Po. Box 9275, Dubai, United Arab Emirates.



**Classification:** 9178 (CN=Middle East); 4300 (CN=Law); 8100 (CN=Financial services industry)
**Descriptors:** Regulation of financial institutions; Legislation; Islam; Religious law
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00412418 105191965

Asset advantage--additional profitability and benefits for Michigan's Community Banks

Pilgrim, Miles

Michigan Banker , v 14 , n 1 , p 22-24 , Jan 2002 **Document Type:** Periodical; News **ISSN:** 1044-1948
**Journal Code:** BMIB **Language:** English **Record Type:** Fulltext
**ARTICLE REFERENCE NUMBER:** BMIB-2063-19
**Word Count:** 1,909

**Abstract:**

Bank Owned Life Insurance (BOLI) has become an investment choice by money center and large regional banks by the late 1990s. Priced on an institutional basis it has evolved to become an attractive earning asset on over 4,000 bank balance sheets throughout the US.

**Text:**

Up until a couple of years ago "BOLI" might have been thought to be either a strange virus or song from the 1960s by many Michigan bankers. That all changed with broad marketplace acceptance of Bank Owned Life Insurance. Actually, BOLI had become an investment of choice by money center and large regional banks by the late 1990s. Priced on an institutional basis it has evolved to become an attractive earning asset on over 4,000 bank balance sheets throughout the United States.

How It Works

Bank Owned Life Insurance or "BOLI" is typically a single premium investment with a highly rated insurance company that enables a bank to record attractive tax-free yields through cash value accumulation and death benefit **proceeds** beginning in year one. This insurance investment re-prices itself annually on the policy's anniversary date and therefore can be compared to a bond that re-prices itself annually. Generally, OCC directive 2000-23 permits banks to deposit into such a plan 25 percent of Tier I capital plus loan loss reserves. The conservative practice is to invest no more than 2 percent of total assets into this program. All earnings are not taxed and/or will be tax free if held to death.

The use of such products has become widespread to offset, as required by the OCC, the annual and future costs of benefits such as health insurance, qualified plans costs, SERPs and director programs. BOLI does not need to be tied to a new benefit program. Frequently executive benefit plans are revised in the context of a BOLI purchase and brought up to current market standards.

The OCC requires diversification among insurers generally governed by a bank's "legal lending limit" to one borrower on an "unsecured basis." Insurers themselves demand diversification between carriers so as to protect themselves from disintermediation. The insurance itself is owned by the bank and the beneficiary is the bank. Participation is limited to senior management only. In addition contracts have no surrender charges and create immediate positive earnings.

Selection Criteria

Given that there are a variety of factors that make up a BOLI portfolio, institutional buyers look to develop an overall framework to evaluate various options. These would include: low credit risk, profitability and predictability.

BOLI is a long-term transaction and credit risk is an important element to clearly understand. Asset Advantage believes a bank should deal with large, proven U.S. companies to minimize the risk that credit becomes an issue. Having a firm grasp of these categories will allow the bank to make an informed decision based on the importance of a combination of all these factors.

Ultimate profitability of the product is a direct function of two components: Gross yield and product expenses. These components of net yield differ considerably between product choices and are more or less attractive based on the interest rate environment when the plan is implemented. Profitability currently favors portfolio general account due to the low interest rate environment and the structure of the product. Each carrier has their own investment philosophy to determine the asset allocation of the underlying general account. Having an understanding of the portfolio will help the bank understand current profitability and how the product will react to changes in the investment environment. We recommend a analysis of executives to be included in the plan, whether they be underwritten or issued on a guaranteed basis, so as to maximize plan yield.

Banking and insurance have never been far from the hearts of the Stoddard and Walsh families. From left: Clune J. Walsh, Jr., Clune J. Walsh, III, Stanford D. "Buddy" Stoddard and (seated) Stanford C. Stoddard.

Understanding the effect of interest rates and mortality over the life of the plan allows the program to be a very predictable source of earnings. Each insurance company portfolio differs in asset allocation and duration.

This, combined with the mortality dynamics of the insured group, allows the bank to develop a highly predictable program.

Tax Issues

Over the past year, there has been concem that the Treasury Department is targeting BOLI to look for transactions that lack economic substance and violate three key components that constitute life insurance: transfer of risk, investor control, and insurable interest. There has already been published IDRs specifically on BOLI, which attack certain separate account arrangements. The general account product structure is the most conservative approach possible to protect the tax treatment of the product.

Satisfied Asset Advantage customers: With Clune and Buddy are David T Provost, president of Bloomfield Hills Bancorp, Inc. and Patrick M. McQueen, president and CEO of Bloomfield Hills Bank.

To qualify as insurance there needs to be substantial "transfer of risk" from the client to the insurance company. With typical life insurance, mortality and investment risk are the two most likely to come under scrutiny in a BOLI transaction. General account transactions clearly have risk transfer in both categories.

Technically, the bank owns life insurance contracts and the insurance company or **investment** manager has total **discretion** over the invested funds. Under general account, the insurance company (or a wholly owned subsidiary) invests funds based on specific investment parameters that buyers of this product analyze in the buying process. This product type has limited investor control risk due to the nature of the fund.

Failing to have insurable interest in those being covered can result in loss of tax treatment of the program. This is looked at in context of Michigan's insurable interest laws and the amount of coverage in place in relation to salary. To be as conservative as possible, we recommend that a bank stay consistent with Michigan's Insurable Interest Laws while weighting the premium commensurate with salary. Simply stated, the executives who are more highly compensated are insured for a larger amount. To minimize risk, we also recommend having death benefits be as low as possible in relation to salary, targeting a ratio of 20x salary or less. Keeping death benefits at a minimum requires the bank to purchase a Modified Endowment Contract (MEC).

Insurance Industry

Many bankers have recently asked questions about the condition of the life insurance industry since September. Moody's recently reported that "U.S. life insurance industry will unquestionably face significantly higher than normal levels of mortality and morbidity claims, as well as investment losses, following the terrorist attacks of September 11. At this early stage, we do not expect the tragedy will result in a significant number of rating downgrades. Our universe of rated life insurers generally have strong capital positions, solid liquidity profiles, and broad business line diversification. As such, the unusually high level of claims should not materially weaken their financial strength and flexibility. Well diversified underwriting discipline and reinsurance programs should protect most life insurers from unusually high levels of losses."

Individual companies have echoed this sentiment. For instance New York Life ball-parked its financial exposure as being in the range of $50 million to $75 million. John Hancock says it thinks the effect of the attacks would "not be financially material and that it continues to expect earnings-per-**share** growth of 10 percent to 12 percent this year." Northwestern Mutual Life also said it had ample liquidity to pay all claims. Overall, the top life insurance companies see a rise in claims of about 3 percent.

Asset Advantage

The company was formed in 1999 based on the opportunity that the partners saw in the marketplace for institutionally priced BOLI at the community bank level. They teamed with The Brown Company of Boston who has access to multiple distribution systems which allow representation of the

bank to the BOLI and benefit market. These channels are responsible for over 80 percent of the current BOLI market. This includes extensive experience with the legal, accounting, and regulatory issues surrounding BOLI and benefit transactions.

Clune J. Walsh, III (left), and Buddy Stoddard.

The Asset Advantage Staff includes (from left), Buddy Stoddard, Linda Burke, Mollie Stern, Maura O'Connor and Clune J. Walsh, III.

"Our combined firms have been involved in over 30 transactions with mid to large community banks. These transactions have ranged from $2 million to $100 million. This broad knowledge of the market allows us to bring the best of the institutional products to sophisticated community banks in Michigan looking to invest in BOLL" Asset Advantage offers both a local expertise as well as an established administration system for regulatory compliance, monthly reporting, ongoing credit and performance reviews.

Asset Advantage builds upon relationships already established and trusted. "We offer a low key approach, less sizzle and no hard sell. Not all bank balance sheets are right for BOLI. A bank has to have the taxable earnings and liquidity."

Historically community banks were generally not offered institutionally priced BOLI because insurance companies were still selling in larger plan sizes and because BOLI was marketed only as a part of a benefit plan. Some of these plans did not tie the modest BOLI returns to plan expenses and wound up under water. Unlike the large bank BOLI where the entire focus is on investment return community banks are more apt to **share** death benefits with executives in an attempt to attract and retain key people.

Stoddard and Walsh were high school classmates and their varied backgrounds in banking and insurance were helpful in founding Asset Advantage.

Stoddard began his banking career as a teller with Michigan National in the 1976. "I'm not sure I was old enough or even qualified, but no one argued." After going through credit training with the bank in Grand Rapids Stoddard attended the University of Virginia where he received his MBA from the Darden School in 1987. He worked in small business and middle market lending for First Union Bank in Atlanta "ostensibly to help clean house after bank mergers in Georgia in the mid 1980s. Oddly, I ended up working many of the profitable, long-term relationships the former banks maintained." Stoddard later returned home to Michigan and worked as an international lender for Comerica Bank in Detroit.

"I have thoroughly enjoyed meeting and working with bankers around the state of Michigan. The vast majority are extremely honest, sincere and down-to-- earth people. A good example is Don Mann, who had a relic from the Michigan National Tower that would be meaningful to my family. Several months later he presented it to me at the 2001 MACB Convention. It is nice to interact with people of Don's character."

Stoddard is the son of Stanford C. "Bud" Stoddard, former head of Michigan National Corporation and chairman of Michigan Trust Bank. "My father has been very innovative and aggressive through the years. I tend to be more conservative and have more of a credit mentality. Working with BOLI has allowed me to help banks focus on improving profitability and benefits without a significant increase in risk. It just makes good sense."

Clune J. Walsh, III is a partner of Creative Compensation Group. His insurance career began 17 years ago as an assistant to the regional vice president of group operations for The Equitable in Chicago. Walsh subsequently became a group account representative before leaving to become a partner with his father in the Creative Compensation Group, a provider of executive benefits for over 40 years. CCG is a member firm of M Financial, the nation's most influential buying consortium of insurance products and services for affluent individuals and highly compensated executives. Stoddard and Walsh can be reached at (248)647-- 9100.

**Special Features:** Photograph
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**Descriptors:** Banks in insurance; Life insurance; Investment products
**Geographic Names:** United States; US
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72/9/7 (Item 7 from file: 608)
06964099
British Insurers Group Aims Toward a Policy of Quality

Tracey Boles
Sunday Business, London
September 16, 2001
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 1281

**Text:**

By Tracey Boles, Sunday Business, London

Sep. 16--As the review to compensate victims of pensions mis-selling draws to a close, the life assurance industry may have thought it had left its Arthur Daley image far behind.

But the debacle at Equitable Life, along with a string of headlines about soaring insurance premiums and insurers discriminating against people with hereditary diseases, has put paid to that idea, again shattering confidence in the industry.

The Association of British Insurers, under the stewardship of Mary Francis, is still hoping to salvage the industry's tarnished reputation with its Raising Standards initiative. Brands meeting certain standards of customer service and transparency across their whole product range will be awarded a quality mark.

An accreditation board has been judging applications for the past year and the first accreditations will be announced mid-October. At least 10 brands are in the process of applying and working up to the standard, but it is not expected all will be ready in time for the announcement. Changing systems and literature are proving the biggest stumbling blocks to meeting the criteria.

The idea for the quality mark arose out of research designed to uncover what would encourage more people to save. The answer was information simply conveyed and easily compared.

The cornerstone of the initiative is transparency -- all charges must be disclosed, for example, although the level they are set at is not dictated. Additionally, providers imposing high exit charges on products that tend to be cashed in early will face a penalty. But how does Francis answer criticisms that the initiative is too expensive -- the application fee is UKpound 20,000 followed by an annual charge -- as well as too little, too late?

"The companies are charged at cost," she says. "The costs are those of running a rigorous and independent system. We can't say standards are cheaper or less testing for smaller companies, but those that are smaller

or have a limited range can discuss costs with us.

"As for it being too little, that is always said with a new scheme. It is not too little -- it is very demanding -- or too late. In terms of comparability of charges and plain English, we are doing more, and more rapidly, than the regulator. The initiative is having an impact on all new products."

She also claims that Raising Standards has been groundbreaking in terms of with-**profits**, the process used by insurance companies to smooth returns which has been lambasted recently for lack of transparency. "We believe very firmly in the principle of smoothing, a vital principle for cautious investors. Some people are buying group personal pensions instead of a stakeholder pension because it gives them access to with-**profits** funds," she says.

"But we also recognise with-**profits** is a bit like medicine which old-fashioned doctors didn't explain. Actuaries have to realise that more openness is needed. In the quality mark scheme we have been working on how we can become more open. Together with the Financial Services Authority, we have realised that changes need to be made, clearer explanation about charges and **investment** policies and annual statements of performance and projections."

Francis defends the **discretion** life companies use when deciding how much they hold back and pay out from with-**profits** funds. "It is left to the skill of the company in judging how much needs to be smoothed from the top or bottom of the curve -- some will be better at it than others. Such discretion is involved in many European products."

She may be able to defend with-**profits**, but surely she cannot do the same for Equitable Life? "The circumstances are unique, namely insufficient funding combined with unwise guarantees and distribution of investment returns."

She says ABI figures do not indicate that Equitable Life has dragged down sales or confidence in the sector. She simply wants to see the crisis at the beleaguered mutual resolved fairly via the compromise deal currently being drafted.

On another thorny issue -- the use of genetic testing in deciding insurance premiums, or whether insurance is granted at all -- Francis says: "The industry believes it is essential for both parties to **share** relevant information. It is about risk. You wouldn't want to be charged the same motor insurance premiums as a 20-year-old.

"It is important to strike a balance. If you have terminal cancer, you won't get insurance because you have gone from risk into certainty. Genetic testing is not so different from other types of medical information if it is reliably predictive."

A moratorium was placed on using the results of such tests last spring unless someone was applying for insurance cover of over UKpound 300,000. But the government is also looking at screening for hereditary breast cancer and various nervous diseases, aside from Huntingdon's, which triggered the original debate.

As for some types of prostate cancer being excluded from critical illness policies, Francis says: "It became necessary to define more tightly which types count as a critical illness. It is not insurers moving the goalposts, it is medical science moving on."

The foundation of the life industry has also been shaken by the arrival of stakeholder pensions, which the government hopes will prompt lower and middle-income earners to save for retirement. Francis recognises its profound importance.

"Stakeholder is very important in bursting through the myth that savings are complicated," she says. "There is some concern in the industry that 1 percent will produce little yield for companies. It certainly squeezes out investment information and advice. The key factor is encouraging people to save, but there is the danger of unforeseen consequences with the government emphasis on squeezing costs rather than advice."

Sales figures for stakeholder may be lacklustre, but it is early days yet -- employers only have to register by 6 October -- and Francis expects sales to take off towards the end of the year. But she recognises more could be done to push the product. She expects renewed calls for advice to be offered as part of stakeholder, or even making their purchase compulsory.

"Compulsion is difficult for the government. Its objective is to increase the proportion of people saving through the private sector. There are three ways of doing that -- generosity, the fear factor or compulsion.

"People are unaware of how little the state pension will be. We want to increase awareness of practical considerations such as these. Low and middle- income earners are precisely those who most need advice of the basic/explanatory kind."

She will be presenting Ron Sandler, who is conducting a review of the long-term savings industry, with evidence of the huge savings gap and the role advice has to play in bridging it. Although worried about review overload, she welcomes Sandler as an opportunity to stand back and take a rational view of the whole industry.

The coming year will be a busy one for Francis. As well as Sandler and its "potentially important recommendations", there is a joint initiative with the Department of Work & Pensions (formerly the DSS) to combat white-collar fraud -- "The people who defraud insurers are the same as those who defraud benefit agencies" -- and on top of all that, her new role as non-executive director of the Bank of England.

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UKpound preceding a numeral refers to the United Kingdom's pound sterling. 

**Company Names:** Association of British Insurers ; Bank of England ; Department of Work & Pensions ; Knight Ridder/Tribune Business News ; Work & Pensions
**Descriptors:** Insurance

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72/9/8 (Item 8 from file: 608)
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Labor Secretary Elaine Chao Has Some Big Issues to Tackle

T. Shawn Taylor
Chicago Tribune
September 05, 2001
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 1621

**Text:**

By T. Shawn Taylor, Chicago Tribune

Sep. 5--Elaine Chao was 8 years old and couldn't speak a word of English when she sailed past the Statue of Liberty at the end of a monthlong journey from Taiwan. Chao, her mother and two sisters came to join her father, who had traveled here three years prior to start a ship

brokerage business. Chao says her family believed in the American Dream, but she never imagined she'd become a member of the Cabinet.

One look at her risumi and her political ascent seems almost predestined. She was a White House fellow who became the protigi of former Secretary of Transportation Elizabeth Dole. She was deputy transportation secretary from 1989 to 1991 and was appointed by President George Bush in 1991 as director of the Peace Corps. In 1992, she was brought in as president of a troubled United Way to right that agency after it nearly fell to an embezzlement scandal involving its past president.

Whispers of a Cabinet position began soon after Chao delivered an impressive speech to the Republican National Convention last year. In January, Chao, 47, who is married to Sen. Mitch McConnell (R-Ky.), was nominated by President Bush to become the 24th secretary of labor. Like the vessel that once carried her past the lady who has welcomed thousands of newcomers, her nomination sailed to approval.

Her job is important to everyone who works for a living in America. Chao has been asked to give the last word on the ergonomics debate after Congress, in March, overturned federal regulations imposed in the final days of the Clinton administration. She's acted as a liaison between labor unions and an administration that has been called anti-labor. And she has established an Office of the 21st Century Workforce to address the employee skills gap, worker shortages and to promote the viability of America's laborers.

Chao recently **shared** some of her thoughts on those issues and others important to workers. What follows is an edited transcript:

QUESTION: What did we learn from three hearings held over the summer to examine whether the federal government should impose ergonomics regulations?

ANSWER: When I testified before Congress on ergonomics earlier this spring, I laid out six principles. One was that any course of action that we take should be based on sound science. It was important to get doctors who had knowledge on this issue, who had actual experience on this type of injury, and hear from them. I think if businesses are irresponsible, they need to be penalized. What complicates this issue is we don't know what is an ergonomics injury. I want to make sure workers are protected. But I want to make sure that whatever course of action the government takes that it is a responsible course of action. I've got an open mind.

Q: What's wrong with the definition of ergonomics injuries we've been using? Why, after tons of research linking repetitive-motion injuries to the job, are we still in doubt?

A: I think that's what these hearings were intended to find out. How do we determine whether an ergonomics injury is work-related or not? What should we do if causality is mixed or unclear? If someone has hurt themselves on their own personal time and they come into work on Monday and they claim that somehow their weekend injury has been exacerbated, how does an employer handle that? We need guidelines. We need a set of rules. All of us.

Q: What do you have to say to critics who have labeled the Bush administration "anti-labor"?

A: I think that's very unfair. I think a parallel question could be `Did the Clinton administration have a totally pro-labor, pro-union stance?' The Department of Labor doesn't represent management, doesn't represent unions. We represent the entire workforce. I've had very good relationships with organized labor. I was head of the United Way of America, which is a full partner with organized labor. I took over at a time when the organization's survival was in peril, and organized labor was very helpful.

Q: Have you identified a common agenda with organized labor?

A: I think training and development. The president's national energy plan will create new jobs. I think this 21st Century workforce is an issue that all stakeholders can buy into. I work very, very hard to find areas of common interest in which different stakeholders can join in and

participate. Unions are very concerned about job opportunities for their rank and file in the new economy. And so I think there are lots of opportunities where I can work with organized labor on training and development of the workforce.

Q: What are the challenges facing the 21st Century workforce?

A: I'm concerned about the flexibility of our workforce, the international competitiveness of our workforce. Any organization will attest to the fact that they're only as good and effective as the people in that organization. The same principle applies to our country. Our economic vitality depends on the quality of our workforce. We have to make sure our workforce is able to keep pace with the changes in the 21st Century workplace. They've got to be better educated, trained, more skilled. Manufacturing jobs are decreasing and service sector jobs are increasing. Many of these jobs go begging because so many Americans lack the requisite skills to fill these jobs. That's a tragedy. It is the role of this department to try and close this skills gap. The solution does not lie solely with the federal government. There is no way the federal government will have enough resources to train every single person in America who needs it. We need to partner with the private sector and the non-**profit** sector to ensure that the training programs are providing the best training possible and that they are resulting in individuals landing jobs.

Q: Cities and counties experienced major cuts in training dollars for dislocated workers this year. Is this type of government aid on its way out?

A: That's not true at all. There's a $1.7 billion excess in training funds from the previous years. In fact, the training dollars exceed the capacity of the system to absorb at this point. The money is block-granted to the states. In fact, it's less federal government control. More control is passed to the local state governments. They have the **discretion** to spend it how they see fit through the WIA (Workforce **Investment** Act) boards. The WIA boards are being restructured. It's going to take time. I know that a lot of communities are working away at reconstituting these WIA boards to make them more relevant, to make them more inclusive, and I think that's good.

Q: Thousands have been laid off during this economic slump. Should Americans be worried about future employment?

A: It is very, very tough for individuals who have been laid off or suffered in this economy. My heart goes out to them. We at the Department of Labor will do everything we can to ensure that workers who are facing layoffs or are losing their jobs will have ample resources to put themselves back on the track of a new job. We have a whole host of programs that will help workers who are concerned about transitioning. We're facing a shrinking workforce. The Baby Boomer generation is retiring at an earlier age. Long-term trends indicate we will be facing a more permanent worker shortage. There are many other flexible work arrangements that we need to explore.

Q: What job-related issues are most important to working Americans?

A: The fast pace of change and the balance between work and family. I think everyone of us feels like the world is just zooming by us at an accelerated pace. We're living in an information age. What's important is the ability of workers to invest in themselves, keep themselves relevant in terms of work skills, education and training.

Q: Has your immigrant background been an asset in your job?

A: We had very little when we came to America. But we were armed with the greatest of all gifts, and that is a belief in the basic decency and generosity of this country. My parents were enormously aspiring people. They're people of faith ... and they also empowered their daughters to believe that anything is possible in this country. I never expected to be in the Cabinet, but I think it's another testament to the opportunities in this country. I hope that my experience as an immigrant will help me in my current job. It certainly has given me much greater empathy toward

newcomers to this country.
Q: You've held very demanding jobs and have worked a pretty frantic schedule. What impact has this had on your personal life?
A: If there's any regret in my life, it is that I wasn't able to start a family. I think that's another example of where you just can't have everything in life. I think younger women nowadays, perhaps I won't say they have an easier time, but they have a different set of challenges. A lot of older women have not been able to achieve balance at work and family life. But I've been blessed in many, many other ways. I have a wonderful husband. He's very supportive. And we have a wonderful marriage, and we have a lot of fun together.
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To see more of the Chicago Tribune, or to subscribe to the newspaper, go to http://www.chicago.tribune.com/


**Company Names:** Chicago Tribune ; Department of Labor ; Knight Ridder/Tribune Business News ; Liberty ; Office of the 21st Century Workforce ; Peace Corps ; T Shawn Taylor
**Descriptors:** Government

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72/9/9 (Item 9 from file: 608)
06791523
The Seattle Times Stock Market Column

Greg Heberlein
July 19, 2000
**Document Type:** NEWSPAPER **Record Type:** FULLTEXT **Language:** ENGLISH
**Word Count:** 853

**Text:**

By Greg Heberlein, The Seattle Times
Jul. 19--MESSAGE IS MIXED FROM MICROSOFT: Not so long ago, a big **profit** report from Microsoft could guide the entire stock market higher.
But after yesterday's down day on Wall Street, are Microsoft's financial results -- released after the market closed -- enough to hoist prices marketwide?
Scott McAdams, a longtime Microsoft analyst and co-founder of McAdams Wright Ragen brokerage in Seattle, said there was plenty of good news from Microsoft, but also some that was mediocre.
"I'd say the good news is the revenues were in line and the earnings per **share** were a little better than expectations," Mc-Adams said, "but the quarter was still kind of anemic."
Operating **profit** for the latest quarter was actually less than that in the same quarter a year ago. But McAdams noted the year-ago quarter contained some "fluff" that meant the latest quarter was about 3 percent better.
"Still, that's quite a long way from increases we use to have," McAdams said, referring to 20-percent-plus growth in the past.
He pointed out that deferred sales of $357 million were extremely strong and could have been mixed in last quarter to make the numbers more

impressive.

On the other hand, **investment** income, over which Microsoft has some **discretion**, was more than double the year-ago number.

Despite the mixture, McAdams remains a bull on Microsoft, believing the second half of 2000 will see the Windows 2000 operating system carrying Microsoft higher.

The market, meanwhile, remains hostage to Federal Reserve Board Chairman Alan Greenspan, McAdams said. If Greenspan engineers another soft landing, "we could be OK." A harder landing -- too many interest-rate increases -- could make a bumpy road.

That said, McAdams said the market has tested the lows for the year. The market could still drop, he added, but not to the depths of March.

Yesterday was nothing but drops. The Dow Jones industrial average fell 64.35 points, or 0.6 percent, to 10,739.92. The Nasdaq composite average, up four straight sessions, retreated 97.50 points, or 2.3 percent, to 4,177.17.

Microsoft rose 31.3 cents to $78.50 at the close of yesterday's regular session and traded above $80 through much of the after-hours trading before closing the extended session at $78.875. Boeing, which reports its results about 5:30 a.m. Seattle time today, gained $1.156 to $45.125.

Plum Creek Timber fell 43.8 cents to $27.188, but after the close of trading the Seattle company said it was buying the timber unit of Georgia Pacific in a deal worth about $4 billion.

FreeShop.com, as cheap as $5.25 last week, picked up $1.125, or 20 percent, to $6.625. The most recent news on that Seattle provider of Internet marketing services was an alliance a week ago with Microsoft.

After tumbling from a March high of $150, including Friday's $37 plunge, Extended Systems presents value to some. The Boise maker of links between hand-held computers and networks tacked on $3.25 to $56.

Epoch Pharmaceuticals, available for less than $7 last month, climbed $1.375 to $13.25. The Redmond biomedical company picked up a patent last week.

Two veteran companies reporting **profits** during the next week saw their **shares** pick up steam. Seattle biotech Immunex added $3.063 to $60.938. Bellevue truck-maker Paccar gained $2.188 to $44.563. Immunex is expected to report today, Paccar on Tuesday.

Primus Knowledge Solutions' stock, off $6.063 Monday, fell $8.25, or 18 percent, more to $38. It once traded at $137.25. The Internet software company reported quarterly figures after the session closed and said its chief financial officer had resigned.

After four straight sessions in which Go2Net advanced $14.25 and investors guessed correctly about quarterly **gains**, the Seattle stock fell to the short-termers, down $7.125 to $50.875.

Other Internet-related stocks on the defensive were InterNap Network Services, off $4.188 to $49.875; WebTrends, off $5.375 to $37.125; and Digimarc, off $1.469 to $24.781.

WatchGuard Technologies plunged $7 to $63. Minutes after the close, the Seattle Internet-security company reported a loss for the quarter.

Dendreon, a Seattle biotech that hasn't had a losing week since it came public June 16, shed $1.50 to $19. It was reported that Microsoft co-founder Paul Allen owns 19.3 percent of Dendreon.

In the past two months, Microvision more than doubled, from $22 to $54.375, so a sell-off of $2.875 to $50.25 had the scent of **profit**-taking. The Seattle company applies virtual display technology for direct-to-the-retina imaging.

Information from Bloomberg News is included in this report.

Greg Heberlein's phone number is 206-464-2267. His e-mail address is gheberlein@seattletimes.com.

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**Company Names:** Bloomberg News ; Boeing ; Epoch Pharmaceuticals ; Extended Systems ; Federal Reserve Board ; Georgia Pacific ; Immunex ; InterNap Network Services ; Knight Ridder/Tribune Business News ; Mcadams Wright Ragen ; Microsoft ; MESSAGE IS MIXED FROM MICROSOFT ; Paccar ; Plum Creek Timber ; Primus Knowledge Solutions ; Seattle Times ; WatchGuard Technologies
**Descriptors:** Banking/Economy/Personal Finance/Stocks
**Ticker Symbols:** MSFT; BA; PCL; FSHP; GP; XTND; EBIO; IMNX; PCAR; PKSI; WGRD; INAP; GNET

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72/9/10 (Item 10 from file: 268)
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The supervision of bank asset management activities
Miller, Dean
Trusts & Estates , v 139 , n 3 , p 54-60 , Mar 2000
**CODEN:** TRUSB9 **Document Type:** Periodical; Feature **ISSN:** 0041-3682 **Journal Code:** TRE
**Language:** English **Record Type:** Fulltext
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**Abstract:**

This paper addresses the asset management activities of banks and those carried on by non banks. While labels given these activities by the 2 groups may vary, and there may yet exist minor variations between bank and non-bank versions, except for the bank bona fide fiduciary relationships, in substance these activities are the same. Yet the banking regulatory agencies have been unable to provide a system of supervision which safeguards the interests of the affected bank customers uniformly, comprehensively or effectively. This should be recognized and corrected.

**Text:**

THIS ARTICLE ADDRESSES THE asset management activities of banks and those carried on by non banks.

While labels given these activities hy the two groups may vary, and there may yet exist minor variations between bank and non bank versions. except for the bank "bona fide fiduciary" relationships, in substance these activities are the same. Yet the banking regulatory agencies have been unable to provide a system of supervision which safeguards the interests of the affected bank customers uniformly, comprehensively or effectively. This should be recognized and corrected.

The title for this 17 work is misleading, in that it SLIggests a much broader scope than I am going to provide, In addition, it may he academic in many respects, because the question of what is the permitted degree of interaction between banks and the securities markets in the coming millennium has been decided. at least initially, by the Gramm-Leach-Bliley Act, and that decision has also provided what may be an initial resolution

of the narrower issue of the Supervision of the particular functions and activities with which I will deal. As is often the case in events of this nature, however, what Congress accomplished in this respect will require some interpretation. While the ultimate interpreter will be the courts, at least until Congress returns to the issue, in the interim, the task will be undertaken by the affected regulatory agencies of the affected industries. Yet it is rnv belief that this should be regarded as no more than an interim solution, to be followed sooner or later by a more comprehensive decision as to the government supervisory structure of asset management activities,

Accordingly, this discussion will deal with the somewhat esoteric issue of what would be the ideal result in this area when, and if, that decision is reached - with special emphasis as to the supervision of the provision of asset management services by financial inStitutions. It represents my opinion solely, and does not necessarily reflect that of my previous associates at the OCC; neither does it reflect the views of the firm with which I ani presently associated. In addition, it may in some respects be unrealistic. This is because the process by which the resolution of this issue may occur is imperfect and may well reflect the protection or enhancement of specific activities already being performed by the affected parties, both private and public, and the addition of new activities desired by them, rather than by comprehensive judgments of right and wrong, logical or illogical, native or alien. Nonetheless, I will try.

During the recent legislative process, unfortunately, the terminology utilized to describe activity in the banking segment of the asset management field became somewhat imprecise and unhelpful, because it occasionally tended to reflect the particular author's conclusion as to what the result should he. The consequence of this was that quite often the end result was the labeling of banking activity with securities industry designations. This characterization in securities terminology of functions which banks are performing brings with it enough securities industry baggage so as to result in a description - or an implicit assumption of a state of affairs - which at least occasionally is at variance with reality. In some cases a particular activity so lal-&-led has unique features in its bank incarnation and has been performed by banks, often without much notice, and perhaps under a different label, for many years. Further, the bank-provided version may have experienced a certain amount Of evolution in this process, which has resulted in some degree of variation in the character of the service as provided at different institutions. This terminological imprecision has served to confuse the issue, for the legislators who were considering the matter, for those who were and are reporting it and - perhaps surprisingly-- even for the government agencies currently or potentially supervising the activity. Let me be more specific. First, as one speaks of hank asset management activities, it should he made clear that we are referring primarily to bank fiduciary activities: some of which may now legally he regarded as constituting participation in the securities business, and some which can not. it may he enlightening. therefore, to review and compare those functions with securities industry equivalents, near-eqUivalents, and non-equivalents.

Yes. that third category, does exist. Some bank fidUCiary activities cannot be considered in any reasonable sense to have securities industry equivalents, and I submit that the recent legislation has affirmed this. These are the obvious ones - acting as trustee, executor, administrator or guardian -- what might be said to be the core bank-- fiduciary activities. These capacities have no real counterpart it) the activities carried on in the securities business. which has found it necessary to charter affiliated thrifts or trust companies to offer them. Accordingly, one would expect that any further legislative delineation of bank "hona fide fiduciary" functions, as against those constituting "securities activity" - to use the terms which might most likely be employed in this effort - Would result in the first group of functions remaining within the range of the former as permitted bank functions, although perhaps with some more precise, and

possibly rather severe definitions. For example, one would expect that unique bank and trust company fiduciary activity might be expected to continue to include the administration of testamentary and inter vivos trusts; at least as long as the goveming instruments were individually produced, somewhat unique, and, possibly, as long as the accounts involved held significant quantities of assets. However, the administration of accounts so labeled which do not meet these qualifications might conceivably be expected, particularly in view of SEC interpretations of what it considers to be bona fide fiduciary activities over the years, to be suspect as constituting engaging in the securities business.

The same might more easily be concluded as to the "near equivalents", -Which would include most of the remaining activities which are being exercised by banks pursuant to their lucia-rv franchise, and some related ones which do not require fiduciary powers. These are variants of the varius bank agency and custody relationships. This group would include activities which have been given labels such as managing agent, or investment advisor-both activities which have been performed by banks for years, usually in conjunction with trust department functions. It is here that the possibility of not being included in a new delineation of banking, as against securities activities, is much greater. The reason is simple-essentially, it is because these are functions, or are very similar to functions, which have also been performed over the years by non bank instiotutions-in many cases, by securities firms or entities closely related to them. While the Gramm-Leach-Bliley Act recognized that "fiduciary capacity" includes any capacity in which a bank exercises **investment discretion**, the now-burgeoning offering of these similar services by the two competing bUt dissimilar businesses. largely pursuant to two dissimilar (and in many respects, also competing) regulatory schemes, has brought Lis to where we are today.

Just where is that? We have banks now offering securities industry equivalents - services which until recently were regarded solely as securities activities, prohibited to banks by the Glass-Steagall Act. These are, of course, the proprietary and the related private label mutual fund activities. While the principal constituent parts of the proprietary fund structure have been performed by banks over the years - acting as investment advisor, administrator, custodian, transfer agent - the combining of all of these into a vehicle which is uniquely the bank's, with an identifying name and a corresponding stake by the bank in its success or failure. is a recent development.

And as such, it complicates the problem -with which %ve are dealing here. For while Gramm-Leach-- Bliley does provide that banks acting as investment advisors for registered investment companies are now subject to the Investment Advisors Act, it does not. in my opinion, resolve the Underlying SUpervison, issues.

The offering by banks of fiduciary services falling in the -non eqUivalent" and "near eqUivalent" categories above has been supervised for the most part hy the banking agencies, with the SEC in the background. The offering by non-hanks of similar, often identical, services has been supervised for the most part by the SEC and the other securities regulators, but of course when an affiliated trust company is employed, with a bank Supervisory element. The supervision of the hank proprietary fund activities has fallen somewhere hetween the two categories being sol-hat more equally **shared**, and with more overlaps. iThe placing of the banks operating these funds under the InVeStment Advisors Act will not significantly alter this. What must he here recognized is that this SUpervision by the two different government agency groups of identical and quasi-identical Functions has not been identical. And when, as often happens, each supervisor@, group his done its own thing without coordination with the other, the I)roceSS has differed SLub-stantially.

And therein lies the point of this article. It is that we can no longer afford this incongruity in our legal and SUpervisory systems because of the growing size of the institution which are performing these

essentially identical activities and more especially, because of the increasing scope of those activities The securities business. hank and nonbank version, should ideally be regulated identically, by one supervisor. My conclusion is that that supervision Should come from the present securities supervisors. I believe that an analysis of the banking supervisory system for this area supports that conclusion.

The supervision of banks has from its inception had as its principal Purpose the protection of the safety and soundness of the banking system. Indeed, for many years. thai Vais its onN purpose. As a result, hank supervision has from its beginning promoted activities and practices which enhance the financial vitality of the banks, and discouraged those which are to its detriment. This has resulted in the development over those years of a predominant philosophy on the part of the bank Supervisory agencies, and particularly those agencies' professionals which gives a controlling priority to the objective of the -safetv and soundness" of the banks under SUperv-ision. Other public concerns, such as redress for breach of some duty to the customers. were later also made the responsibility of the banking agencies - bank fiduciary activity supervision is one such concern - but in fact, these conceres have become viewed institutio(nally as being of lesser priority to safety and soundness, Why? The reasons are manv@ but in the last analysis, I believe it is because the banking agencies themselves are conflicted-torn between the two opposing obiectives - and the result has been that they have in nearly every case. given a higher priority to their first objective. to the detriment of the second. Institutionally, they have been, and remain, less motivated to press a bank to make an aggrieved customer whole if to do so would endanger the bank's soundness, or even if it would weaken it. Once again, let me be specific.

In the banking agencies, the predominant professionals are the so-called "commercial" bank examiners. From the begining. their examining activities consist almost exclusively of analyzing loans-- which is the traditional, conventional and at one time predominant activity of all banks. Some will then progress to investments, which involves them in analysis of the government or municipal securities held in bank portfolios. But few of this group ever become involved in the actual examination of many other areas of banking. such as fiduciary activities, and many of them, consciusly or unconsciusly, tend to denigrate these other areas. Yet as these "commercial" examiners advance within their agencies, they do ultimately have authority over the "specialty areas", as the non lending or investment functions are often referred to. That is because it is from this group of persons historically that the overwhelming majority of the mid-level banking agency professionals have been chosen. And in turn, it is also from this resulting mid-level group that the top level of professional banking agency supervisory executives have almost inevitably been chosen over the years. As a result, most of banking agency supervisory policy is formulated, executed and administered under the influence, and reflecting the philosophy, of these persons.

What about the banking agency examiners who are given the direct responsibility of supervising this "non safety and soundness" activity of the banks, such as fiduciary services? To begin with, this involves work which is radically dissimilar from the commercial bank examination functions. For example, the oversight of a bank's performance of its fiduciary activities requires the making of judgments which are much more subjective, and require more knowledge of the function involved and the law relating to it than is the conventional examination exercise of ascertaining whether a customer is paying his loans, or whether the bonds in the banks' limited investment portfolios have defaulted. As a result, the banking agencies have in large measure had to develop separate specialists for this function. These specialists have had to perform the agency objectives of ensuring the safety and soundness of the banking system through a two-step process.

This is because the threat to a bank's viability from its fiduciary activities Would come from the imposition of liability upon it for failure

to property carry out its responsibilities to the beneficial interest holders of the accounts being administered. The fiduciary activity examiner must therefore first evaluate how well the bank is performing those responsibilities. This process of necessity requires a certain amount of knowledge of the laws and regulations applicable to fiduciaries, It involves both an inquiry as to whether the bank has satisfactory policies and procedures which will ensure that it conforms to those laws and regulations, and also requires forming a judgment, usually based upon a scrutiny of a number of particular accounts being administered, as to whether those policies and procedures are effective.

The second step in this process includes requesting corrective action in instances where it appears that the bank is not conforming to the requirements of the applicable law-, and that fiduciary accounts which have not received the quality of administration and the freedom from conflicting interests which the law requires, be made whole. This second corrective could mean obtaining consents from beneficial interest holders, after proper disclosure. It could mean making the bank reverse particular transactions at no loss to the fiduciary account involved. It could mean requiring that an account be monetarily reimbursed. These corrective actions could be embarrassing, and possibly very costly to a bank.

Commercial examiners have had difficulty embracing this process. Why? One reason lies in the fact that Much of the law applied by the banking regulatory agencies to these activities as performed by banks is the common law of trusts, supplemented here and there by specific state statutory enactments and the regulations of the banking agencies. This law does not, like the securities laws, provide a clearly defined and comprehensive catalog of specific rules and regUlations concerning fiduciary activities, but rather, tends more to prescribe basic duties, i,e. loyalty and prudence, which must be applied to a wide variety of specific fact situations. Lawyers, bankers and bank examiners sometimes differ as to the application of those duties in particular contexts. Courts (and members of Congress) do as well. The absence of clearly defined specific answers which none will question results in some measure in a reluctance of banking agency supervisors to support their fiduciary specialists.

Because of this, the bank regulatory agency commercial examiners, and their commercial examiner oriented superiors, have proved repeatedly to be unenthusiastic about this process, both subconsciously and occasionally openly.

It simply runs counter to their primary orientation. To require the acquisition by a bank of an adequate staff of competent fiduciary personnel, and the establishment of organizational structures and the formal policies and procedures necessary to ensure that fiduciary responsibilities are properly exercised, is costly. To insist upon the avoidance of actions involving a conflict of interest on the part of the bank may be difficult for them to understand, especially when a sound asset held by the bank. or the interests of a competent and respected director or officer of the bank. are involved. And requiring that a monetary compensation he made to a particular fiduciary account, especially in a circumstance where no beneficial interest holder of that account has complained (which often happens, because the tatter are unaware of it, given the secrecy of the bank Supervisory process), has at times been difficult for the commercial bank examiner to comprehend and embrace; particularly if. as also occasionally has been the case, the bank's management is uncooperative.

This attitude on the part of the banking agency professionals has had its effect on the agencies overall - it is a somewhat less than militant attitude when it comes to possible bank misdeeds concerning matters other than the conventional hanking functions. The result of this institutional attitude has been that fiduciary supervision has, over the long run, been given a secondary priority at the banking agencies. The norm is for examination plans, in terms of personnel and time allotted to the Various bank activities. to be based on commercial bank supervisory objectives and

concerns. Staffing his reflected this norm as well. A reCurrent scenario is for fiduciary examination plans to be scheduled within the times which have been planned for the commercial examination, utilizing the specialized personnel who happen to be available at that time.

In all fairness, it must he recognized that this picture has had its exceptions. Upon occasion sonic of the bank regulatory agencies have made the decision to give greater emphasis to this function, and established programs which have provided an improved supervisory process for bank fiduciary activities, Also upon occasion. the agencies have actively recruited and trained specialized examiners to perform the examination function for these activities, resulting for a time in a specialized complement which satisfied, or at least was closer to examination needs. Invariably however, these programs have proved to be temporary, and the agency has reverted to the "norm", perhaps in response to the next commercial banking crisis, or perhaps reflecting the periodic cost-cutting exercises - with the result being that specialized examinations once again have become Unsupported and understaffed and been given inadeqUate time frames for completion. Inevitably a long-range corollary of this process has been that the specialists have come to realize that their work is not appreciated, and that promotion possibilities within their agency are. limited. The result is that in turn, many competent fiduciary examination personnel either leave the agency or transfer to other areas of activity. The ones who remain - and some of this group are very competent and dedicated persons - are understaffed and unsupported. This melancholy story is essentially the same in all of the banking agencies, and has been repeated over and over.

In addition, we must recognize that a coordinated and uniform oversight does not exist as to the asset management business as it is conducted within the present banksupervisory structure. These banking entities are regulated, in greater or lesser degree, by a variety of supervisors - the Comptroller of the Currency, if the institution is a national bank, the Office of Thrift Supervision if a federal thrift charter is utilized; and the appropriate state bank supervisor, if it is a state hank or trust company. If a state chartered bank or trust company is also a member of the Federal Reserve System, it is supervised as well by the. Federal Reserve. If it is not, but is inSUred, it is supervised by the Federal Deposit Insurance Corporation in addition to the state hank Supervisor. However, most of the state chartered trust companies escape federal supervision, because they do not accept deposits, and therefore are not subject to the FDIC; and they do not join the Federal Reserve System, The supervision by state hank supervisors of these trust companies presents a varied picture. Some state banking departments are well staffed for this function, and do an excellent job. Many are not, however, and trust company supervision is minimal to nonexistent in some states.

Other disparities exist. National banks are subject to the rather detailed regulations of the Comptroller of the Currency as to the operation of their collective investment funds. State banks, however, are subject to only the portion of the Comptroller's regulation relating to common trust funds - their collective investment funds for qualified pension and **profit** sharing trusts are not subject to the Comptroller's regulation; and often these funds are subject to no comparable regulations on the part of state banking authorities.

Banks and trust companies enjoy exemptions from the Securities Act of 1933 and the Investment Company Act of 1940 for their common and collective investment funds. These exemptions were extended to thrift institutions by the recent legislation. Similarly, banks, but not thrift institutions, also have exemptions from the Investment Advisors Act (except, as a result of Gramm-Leach-Bliley, for when they advise registered investment companies). The result is that there is no uniformity of supervision of the provision of asset management services among the banking and thrift institutions, as conducted by the banking and thrift supervisors.

By contrast, the supervision of similar activities at non-banks (and

at banks, to the extent applicable) by the securities supervisory agencies is oriented much differently. The Securities and Exchange Commission, and the securities industry self-regulatory agencies, apply an oversight system to these activities that is markedly dissimilar to that described above, For the most part, the safety and soundness of the business entity performing the functions is given the secondary importance. Compliance with a lengthy set of specific laws, rules and interpretations, backed up by extensive disclosures, are the principal underpinnings of this supervisory system. There is much less room for difference of opinion as to whether one of the specific requirements has been breached. it is there in the form of a detailed law or regulation, or an interpretation, or a no action letter governing a specific action, which makes clear what that agency requires. Similarly, the range of prescribed corrective actions for such violations is generally more specific. Finally, there exists a greater reluctance on the part of the regulated entities to differ with the SEC, which appears to have a philosophy that if the correction of a violation might also result in the failUre of the company involved, so be it. The result is a system which gives a more uniform redress to wronged customers of the nonbank asset managers, and does so for the most part in a public forum, so that all are aware of the failings of the offender.

The performance by these two groups of asset managers of often identical services, subject to such dissimilar supervisory structures is an anomaly for which justification no longer exists. The dual system was more valid when banks were limited to offering bona fide fiduciary services, and their entry into the field of selling **shares** of pooled investment vehicles was deemed prohibited by the GlassSteagall Act. And in fact, for many years the services being offered by banks pursuant to their fiduciary powers - even the collective investment of assets acquired through those services - were quite dissimilar from the sale of **shares** of an investment company managed by the bank. When this state of affairs prevailed, it was at a time when the banking business consisted overwhelmingly of lending, and the performance of trust services was distinctly a minor activity. Subjecting the business as then conducted to the requirements of the Securities Act, the Investment Advisors Act and the Investment Company Act was not warranted by the nature of the services being performed - it would have made them impossible to conduct, and prohibitively expensive, for the most part. Under those circumstances, a supervisory approach which balanced the concern for the beneficial interest holders of fiduciary accounts with the high priority for maintaining the bank as a going concern was perhaps more appropriate.

However, as we all know, the nature of banking, and the role of fiduciary services in the banking equation, has evolved markedly over the years. Banking has become but one small element of the financial services industry-in many cases, but one small part of a combination of activities which Support the whole. Lending is no longer the major income producer in many financial services cornpanies. Trust services, by contrast, have grov,,n into asset management services. and have become a much more significant contributor to the income of these financial services companies - in some instances the major contributor. And in the process, these services have come to include securities activities. Assisted by the gradual el-0sion of the impediments of the Glass-Steagall Act, and the development of new. integrated if)proaches to the provision of asset management services such as private banking, the participation of banks in the businesses formerly conducted solely by securities firms became a fact. even before the final legislative recognition of that truth this year. The fact that many banks also continue to conduct a traditional banking and a traditional trust department business; and that some securities fil-111S now- conduct a somewhat traditional trust company busineSS through affiliates, only, highlights the necessity of subjecting these activities to more coordinated, if not identical government oversight.

In the coming months. this circumstance should he a matter of concern for hot the bank and the securities superviSors, and I anticipate that both

will undertake to deal N with it. Hover, as we have seen, the dissimilar orientations of the t@vo supervisory strUCtUres make the approach of each to this concern significantly different. With the bank supervisor, one wold expect the interest to be the same as with the other risks which a bank's fiduciary activities entail. and the agency outlook also the same - yes, he concerned about the widows and orphans, bUt the ,safety and soundness of the bank is supreme. The securities supervisors approach is also the same here as it is in other contexts - investor protection and the integrity of the securities markets concerns are supreme, even if a business or bank - must fail here and there in the process.

As to the asset management business, both as conducted by banks and nonbanks, it should be clear from the foregoing that the second set of governmental considerations most prevail for the "equivalents" and "near equivalents". but probably not .is to the "non equivalents", the -hona fide fiduciary" functions. But even as to these, some fashion of achievement of uniformity by the hanking regulators is desirable. This, plus the increasing awareness of this area by the plaintiffs attorneys, and the emergence of beneficial interest holder groups, may be sufficient to ensure that these activities command a more equal respect as safety and soundness concems with the thanking regulators.

In addition, however, the banking agencies and the SEC need to come together to establish a uniform and coordinated approach to all the categories. The abortive joint examination programs undertaken to date have fallen prey - at least on the banking agency side - largely to the hostilities of their commercial examiner oriented managements, in my opinion@ they ShOUld be reestablished as an integral part of this uniform, coordinated approach. The Gramm-Leach-Bliley Act provides an 18-month period prior to the effectiveness of many of the changes giving the SEC greater authority in this area. It would appear to he an appropriate interval for that agency and the banking agencies to work to achieve this uniformity and coordination.

The specifics of how to accomplish these objectives, to the extent that Congress does not resolve them in some fashion in the near future. belongs to some other work. My final observation is that if we can't abide the risk to bank solvency which the foregoing recommendations of SEC and banking agency interaction - indeed, SEC supremacy - would involve - however small it is in fact - then the question of insulation, or indeed, of continued bank participation in this activity at all, should be reviewed. But that also is not a part of this work,

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Securities, trust, and mutual fund provisions of the Gramm-Leach-Bililey Act: A summary
Anonymous

ABA Trust Letter , v 408 , p 5-12 , Nov 1999 **Document Type:** Periodical; News **Journal Code:** BTRL **Language:** English **Record Type:** Fulltext

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**Abstract:**

A summary of the securities, trust, and mutual fund provisions of the Gramm-Leach-Bliley Act is presented.

**Text:**

NEW ACTIVITIES

Title I of the Gramm-Leach-Bliley Act establishes a new framework for determining what type of nonbanking activities are permissible for bank holding companies or financial holding companies, as they are soon to be called. Currently, section 4(c )(8) of the Bank Holding Company Act of 1956 (BHCA), 12 U.S.C.1843(c )(8), permits bank holding companies to acquire any company that the Federal Reserve Board (Board) has determined "to be so closely related to banking as to be a proper incident thereto That standard will now change, under new section 4(k) of the BHCA, to "financial in nature or incidental to such financial activity" or "complementary to a financial activity."

Under new section 4(k), certain activities are listed as being "financial in nature" including "underwriting, dealing in, or making a market in securities," and "merchant banking," In addition, national banks and state banks (if the state bank chartering authority permits) may engage in certain "financial in nature" activities through financial services subsidiaries. Activities prohibited to financial services subsidiaries include merchant banking but not securities underwriting and dealing.

To engage in these new activities, all depository institutions of a financial holding company must be well capitalized, well managed and have no less than a satisfactory Community Reinvestment Act (CRA) rating. Assuming these conditions are met, a financial holding company need only provide written notice to the Board within 30 calendar days after commencing the financial in nature activity or acquiring the firm engaging in that activity.

Title I is effective 120 days after enactment or March 11, 2000.

BROKERDEALER PROVISIONS

Banks are currently exempt from registering as broker-dealers under the Securities Exchange Act of 1934. Under the Gramm-Leach-Bliley Act, banks will lose this blanket exemption. Consequently, if a bank were to engage in brokerage or dealing as defined under the Securities Exchange Act, the bank would have to register as a broker-dealer and be subject to regulation and oversight by the SEC and the National Association of Securities Dealers (NASD). As a practical matter, however, a bank would not register the entire bank. Instead, it would move the securities activities at issue out of the bank and into a separate brokerage subsidiary or affiliate.

The Securities Exchange Act provides that "effecting transactions in securities for the account of others" is a brokerage activity. Arguably, any number of banking activities-including bank networking arrangements and trust and investment management activities-involve "effecting transactions in securities for the account of others." Similarly, the definition of "dealing" ("buying and selling securities for [one's] own account through a broker or otherwise") could impact many legitimate banking activities.

The Gramm-Leach-Bliley Act appropriately recognizes that traditional banking activities involving securities transactions should not trigger broker-dealer registration requirements. Accordingly, the Act lists several exemptions under which banks would not be required to push certain activities out of the bank and into a broker-dealer affiliate (the so-called "push-out" exemptions).

Section 204 of the Act requires that the federal bank regulators, after consulting with the SEC, adopt recordkeeping requirements for banks relying on the exemptions from broker-dealer registration discussed below.

The loss of the blanket exemption from registration and the several push-out exemptions take effect 18 months after enactment or May 11, 2001.

Banking Products In General

Brokerage or principal transactions involving certain "banking products" would be exempt from push-out even if the SEC were to label such a product a "security." The protected banking products are divided into two categories: "identified banking products" and "new hybrid products."

"Identified banking products"

The list of "identified banking products" includes deposits; banker's acceptances ., letters of credit; loans; debit accounts; and certain loan participations. It also includes any swap agreement, including credit and equity swaps, except for equity swaps that are sold directly to nonqualified investors (certain regulated industries, various institutional investors, corporations, and individuals with an investment portfolio of not less than $25 million and any state or local government with an investment portfolio of not less than $50 million). If an equity swap is not sold directly to nonqualified investorfor example, it is sold through a registered broker-dealer-then the instrument may be deemed to be an identified banking product that can remain in the bank.

"New hybrid products"

A new hybrid product is an instrument that is not on the list of "identified banking products" and is also not regulated as a "security" as of the date of enactment of the Gramm-Leach-Bliley Act. The SEC is given initial authority under the federal securities laws to determine, through rulemaking, whether a new product must be pushed out of a bank. The Board can seek judicial review of that determination. The- filing of any petition by the Board operates as a stay of the SECs rulemaking until a final court decision is reached. Moreover, the court is required to make a final determination based on whether the product is more appropriately regulated under the banking laws or the securities laws; the court is directed not to give deference to the views of either the Board or the SEC.

Third-Party Brokerage Arrangements

The Act exempts from push-out support services provided by bank employees to third-party and affiliated brokers in connection with the sale of securities to bank customers. To qualify for the exemption, such networking services must satisfy a number of conditions that closely parallel similar requirements in the Interagency Statement on Retail Sales of Nondeposit Investment Products, which was issued on February 15, 1994, by the Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

These conditions are as follows:

Clear identification that the broker is providing the brokerage services;

Brokerage services are provided in an area that is clearly marked and, to the extent practicable, physically separate from routine deposit-taking activities,

Advertising or promotional materials clearly indicate that the brokerage services are being provided by the broker, not the bank;

Such materials comply with the federal securities laws before they are distributed;

Bank employees perform only ministerial or clerical functions in connection with the brokerage activities (but they can forward customer funds or securities and can generally describe the range of investment

vehicles available);

Bank employees (other than those who are "associated persons" of a brokerdealer) do not directly receive incentive compensation for any brokerage transaction (but they can receive referral fees if the compensation is a onetime cash fee of a fixed dollar amount and the fee is not contingent on a transaction occurring);

All customers who receive brokerage services are fully disclosed to the broker-dealer;

The bank does not carry a securities account of the customer except as a custodian or trustee; and

The customer is informed that the securities are provided by the broker, not the bank, and the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the FDIC.

Trust and Fiduciary Services

If a bank effects a securities transaction in connection with providing trust or fiduciary services, the bank is exempt from pushing these activities out of the bank and into a registered broker-dealer if three basic conditions are satisfied:

First, the bank cannot publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business.

Second, the bank's compensation for effecting transactions in securities must consist chiefly of an administration or annual fee; a percentage of assets under management; a flat or capped per order processing fee that does not exceed the cost of executing the securities transaction for trust or fiduciary customers; or a combination of such fees.

Third, the bank would have to direct all trades of publicly traded domestic securities through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary.

"Fiduciary capacity" is defined under the Act, and although it does not cross-ref erence the OCC's Part 9 definition, it parallels that definition word-for-word.

Safekeeping and Custody

The Act exempts from the push-out requirement any activities conducted in connection with safekeeping and custody services. Such services involve the bank, as part of its customary banking activities, doing the following:

Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;

Facilitating the transfer of funds or securities as custodian or clearing agency, in connection with the clearance and settlement of its customer transactions in securities;

Effecting securities lending or borrowing transactions for customers, and investing pledged collateral for customers in connection with the safekeeping, custody, and clearing activities described above;

Holding securities pledged by a customer to another person, or securities subject to purchase or resale agreements for a customer, or facilitating the pledging or transfer for such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or

Serving as custodian or provider of other related administrative services to any individual retirement account, pension, retirement, **profit** sharing, bonus, thrift savings, incentive, or other similar benefit plan.

As plan custodian or administrator, the bank would have to execute any brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary (similar to the trust exemption).

The Act provides that this exemption will not apply if the bank acts

as a carrying broker for any broker or dealer unless the carrying broker activities are limited to transactions in government securities. Carrying brokerage is not a defined term under the Securities Exchange Act but is generally used to mean having control or custody of customer securities and funds.

This push-out exemption is very important to the banking industry. As more and more individuals change employers or retire, self-directed individual retirement accounts (IRAs) will become important vehicles, allowing consumers to individually manage their 401(k) retirement plan distributions. Under regulations issued by the Internal Revenue Service, banks must offer these IRAs in either a trustee or custodial capacity. Services provided to these accounts by banks functioning in a trustee or fiduciary capacity will be exempt from brokerage registration under the trust exemption. Services rendered by banks as a custodian will also be exempt under this safekeeping and custody exemption.

Stock Purchase Plan Services

Banks that conduct stock transfer agency activities sometimes effect transactions in securities in connection with employee benefit plans, dividend reinvestment plans, and issuer open enrollment plans. Such transactions in securities would be exempt from push-out if three conditions are satisfied:

First, the bank could not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plans. However, delivery of the types of written material permitted by the SEC as of the date of enactment (or as permitted by the SEC in the future) would not trigger a push-out.

Second, the bank could not net shareholders' buy and sell orders other than for programs for odd-lot holders or plans registered with the SEC. (This condition would not apply to employee benefit plan activities.)

Third, as with the trust exemption, the bank would have to execute any, brokerage transactions through a registered broker-dealer (which could include an affiliate), except for certain cross trades made by the bank or between the bank and an affiliated fiduciary.

MUTUAL FUND PROVISIONS

The Act permits bank holding companies, through either a subsidiary of a bank or through a nonbank subsidiary, of the holding company, to underwrite and distribute mutual funds, including third-party mutual funds. In addition, Section 32 of the Glass-Steagall Act is repealed, thereby permitting common officers, directors, and employees between a bank and a registered investment company.

These provisions are effective 120 days after enactment or March 11, 2000.

The amendments to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 discussed below are effective in 18 months, or May 11, 2001.

Investment Adviser Registration

Banks would lose their blanket exemption from investment adviser registration under the Investment Advisers Act of 1940 only with respect to their investment advisory activities involving registered investment companies. All other investment advisory activities conducted in the bank, including bank investment advisory activities involving private equity and other unregistered mutual funds, would continue to be exempt from federal investment adviser registration requirements.

Investment adviser registration will subject bank mutual fund investment advisory activities to regulation by the SEC under the Investment Advisers Act of 1940. That Act and the rules promulgated under the Act regulate advertising, solicitation, and receipt of performance fees by registered investment advisers. In addition, investment adviser registration requires establishment of procedures to prevent the misuse of non-public information; maintenance by the adviser of certain books and records; supervision of investment advisory firm employees; compliance with the general antifraud provisions of the federal securities laws; and

statutory disqualification from performing certain services for a mutual fund if the adviser violates the law.

With respect to bank or bank-affiliate registered investment advisory activities, Section 220 of the Gramm-Leach-Bliley Act encourages the SEC and the federal banking agencies to coordinate and **share** with each other examination reports, records, and other information, presumably in an effort to reduce regulatory burdens associated with becoming a registered investment adviser.

The "SEDD" Option

In an attempt to give banks the maximum flexibility to structure their investment advisory business in a way that makes the most business sense, the bill provides that banks may register their in-house investment advisory units as "separately identifiable departments or divisions" or SIDDs. In this way, banks, though required to register as investment advisers, may keep their investment advisory units in the bank, in a bank subsidiary, or in a holding company subsidiary.

Banks contemplating this option should be aware that Arthur Levitt, Chairman of the SEC, testified that investment adviser registration will give SEC examiners the ability to review bank mutual fund adviser's activities in order to compare trading activity in a mutual fund portfolio to that in the bank's trust accounts and determine whether there has been an improper allocation of orders (May 5, 1999, testimony before the House Commerce Committee on H.R. 10). Although the trust industry is united in its belief that investment adviser registration does not give the SEC the ability to look at individual trust account transactions, banks weighing investment adviser registration options should factor into their analyses this claim of authority on the part of the SECs Chairman.

Common Trust Funds

New Thrift Power

The Act revises the definition of "bank" for the purposes of the Investment Company Act of 1940. Under amended Section 2(a)(5)(A) of the Investment Company Act, "bank" is defined to include "a depository institution (as defined in section 3 of the Federal Deposit Insurance Act)." Section 3 of the Federal Deposit Insurance Act defines "depository institution" as "any bank or savings association." "Savings association" is, in turn, defined as any federal savings association chartered under the Home Owners' Loan Act or any state savings association chartered under the laws of its state. As a consequence, the exemption from registration for bank common and collective funds under Section 3(c)(3) and 3(c)(11) of the Investment Company Act has now been expanded to include common and collective pooled funds offered by thrift institutions.

Interests in these pooled funds are also exempt from registration under the Securities Act of 1933. Specifically Section 3( a)(2) of the Securities Act cross references the definition of "bank" under the Investment Company Act of 1940 in connection with exempting from the registration requirements interests in bank common and collective funds. As a result, both the interests in bank common and collective funds, as well as the funds themselves, are exempt from SEC registration. This new thrift power will make the thrift charter much more attractive to those financial institutions interested in offering trust and fiduciary services to their clients.

Codification of SEC No-Action Letters

The Gramm-Leach-Bliley Act codifies existing SEC no-action letters with respect to the common trust fund exemption from registration under the federal securities laws. Specifically, the exemptions from registration under the Securities Act, the Securities Exchange Act of 1934, and the Investment Company Act require that:

The common trust fund be employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for "fiduciary" purposes (Title 11 of the Act defines "fiduciary capacity" as "(i) in the capacity as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or

custodian under a uniform gift to minor act, or as an investment adviser if the bank receives a fee for its **investment** advice; (ii) in any capacity in which the bank possesses **investment discretion** on behalf of another; or (iii) in any other similar capacity.");

Interests in the fund are not advertised, except in connection with the ordinary advertising of the bank's fiduciary services, and are not offered to the general public; and

Fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable federal or state law.

The first two conditions of the exemption are drawn from current SEC no-action letters interpreting the exemption from registration under Section 3(c )(3). The fees and expenses requirement is intended to ensure that any fees and expenses charged by the fund are measured against fiduciary principles established under the Employee Retirement Income Security Act, Part 9 administered by the OCC, or state statutory, decisional, or common law addressing fees and expenses in connection with fiduciary principles of law.

Mutual Fund Custodians

The Act gives the SEC authority to adopt rules and regulations and issue orders prescribing conditions under which a bank or an affiliate can serve as custodian to an affiliated registered investment company or a unit investment trust. Many banks currently serve as custodians to third-party and affiliated mutual funds, and this provision does not contemplate putting an end to this activity. Rather, the Act now gives to the SEC explicit authority to adopt rules concerning bank self-custody activities but, at the same time, requires the SEC in promulgating Self-custody rules and regulations to consult with and take into consideration the views of the federal banking agencies.

Bank Lending to Affiliated Mutual Funds

Section 212 prohibits persons affiliated with a registered mutual fund, including a bank, from lending money or property to the registered mutual fund or any company controlled by the fund except in accordance with SEC rules. (An "affiliated person" is generally defined under the Investment Company Act by reference to concepts of control (direct, indirect, or common control).) In connection with promulgating any such rules, the SEC must consult with, and take into consideration the views of, the federal banking agencies.

Mutual Fund Boards of Directors

Currently, registered mutual funds are prohibited from having a majority of their board of directors consist of officers, directors, or employees of any one bank. Section 213(c) would expand the prohibition to include officers, directors, and employees of any one bank (together with its affiliates and subsidiaries) or bank holding company (together with its affiliates and subsidiaries).

Currently, the Investment Company Act limits the composition of registered mutual fund boards to no more than 60 percent "interested persons." The Act expands the definition of "interested persons" to include any person who, during the preceding six months, executed any portfolio transaction for, engaged in any principal transactions with, distributed **shares** for, or loaned money or other props erty to the registered investment company, any related **investment** company, or any account for which the **investment** adviser has brokerage placement **discretion**.

Disclosure

The Act takes a page out of the federal banking agencies' Interagency Statement on the Retail Sales of Nondeposit Investment Products by making it unlawful for any person selling **shares** of registered mutual fund **shares** to represent or imply that the security:

Has been guaranteed, sponsored, recommended, or approved by the United States, or any agency, instrumentality, or office of the United States;

Has been insured by the FDIC; or

Is guaranteed by or is otherwise an obligation of any bank or insured depository institution.

The Act also codifies guidance issued by the SEC in May 1993 concerning mutual funds advised by banks or, alternatively, sold through banks (in a letter from Barbara Green, Deputy Director of the SEC Division of Investment Management, dated May 13, 1993). Specifically, the Act requires prominent disclosure of the fact that the FDIC or any other government agency does not insure mutual fund **shares**. If the SEC is to adopt rules and regulations or issue orders concerning such disclosure, the Act mandates that the SEC consult with, and take into consideration the views of, the federal banking agencies.



**Classification:** 8130 (CN=Investment services); 4320 (CN=Legislation); 9190 (CN=United States)
**Descriptors:** Financial Services Modernization Act 1999-US; Securities; Trust departments ; Mutual funds; Banking law
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72/9/12 (Item 12 from file: 268)
00376528 46343385
Cash collateral fund qualifies as common trust fund
Anonymous
ABA Trust Letter , v 407 , p 11-12 , Oct 1999 **Document Type:** Periodical; News **Journal Code:** BTRL
**Language:** English **Record Type:** Fulltext

**Word Count:** 584

**Abstract:**

In an August 1999 trust interpretive letter, the Office of the Comptroller of the Currency (OCC) addressed a state-chartered bank's query whether a proposed fund to hold cash collateral held in connection with securities lending arrangements would qualify as a common trust fund under 12 CFR 9.18(a)(1). The OCC opined that, under the arrangement as described, the bank will clearly exercise a true fiduciary purpose in managing these funds collectively because it would exercise discretion in managing the funds received under the trust agreement and would provide related administrative services.

**Text:**

On an August 1999 trust interpretive letter, the Office of the Comptroller of the Currency (OCC) addressed a state-chartered bank's query whether a proposed fund to hold cash collateral held in connection with securities lending arrangements would qualify as a common trust fund under 12 CFR 9.18(a)(1). The OCC's opinion was confined to the pool's status. It did not address whether the common trust fund was operated in conformity with OCC regulations because the bank is not subject to OCC examination and supervision.

The Situation

The bank offers a securities lending program to its clients in conjunction with its custodial services. Under the program, custodial clients (securities lenders) lend eligible securities to qualified borrowers, who provide noncash collateral (such as government securities) or cash collateral in the form of wiretransferred or clearinghouse funds. Qualified borrowers are primarily securities broker-dealers and other financial participants involved in market making, hedging, and arbitrage transactions.

Under the securities borrowing agreement, the bank has the right to invest the cash collateral for the sole account and risk of the securities lender. The bank proposed to commingle funds it receives as cash collateral in one or more common trust funds for collective investment under a written plan that establishes the common trust funds.

The bank would enter into a trust agreement with each securities lender invested in the fund. The securities lender would be the settlor and beneficiary, the bank would be the trustee, and the body of the trust would consist of all of the security lender's rights with respect to cash collateral.

The rights of the securities lender would include the right to possess the funds constituting cash collateral, to invest the funds, and to retain the earnings on the **investment** of the funds. As trustee, the bank would retain **discretion** under the trust agreement with each client to manage the cash collateral on a pooled or nonpooled basis. Fiduciary administrative services performed by the bank would include safekeeping the collateral, collecting the income due to the beneficiaries, and paying the income as directed under the trust agreements.

The common trust funds would seek to maximize income by investing in high-quality fixed-income or adjustable-rate securities and other instruments. The units of each fund would entitle each participant trust to a pro rata **share** of the income, expenses, **gains**, and losses of the fund.

The bank also represented that, in all other aspects, the trusts would comply with Regulation 9, Illinois laws, and any other applicable laws.

Finally, the bank represented that the funds would rely on either Section (3)(c)(1) or 3(c)(7) exemptions from registration under the Investment Company Act.

A True Fiduciary Purpose

The OCC opined that, under the arrangement as described, the bank will "clearly exercise a true fiduciary purpose in managing these funds collectively" because it would exercise discretion in managing the funds received under the trust agreements and would provide related administrative services. Thus, the proposed funds would qualify as (a)(1) common trust funds under 12 CFR 9.18.

In making its finding, the OCC confirmed that investing cash collateral held in trust in connection with securities loans is a "fiduciary" function.

The OCC's interpretation was also significant because it agreed that a securities lender has rights to hold and invest cash collateral, even though neither the securities lender nor the trustee own the collateral. Thus, the rights to hold and invest cash collateral is deemed to be "property" which may be held in a trust which, in turn, may participate in a common trust fund.



**COMPANY NAMES:** Office of the Comptroller of the Currency, NAICS:926150
**Classification:** 8130 (CN=Investment services); 4310 (CN=Regulation); 9190 (CN=United States)
**Descriptors:** Trust departments; Fiduciary responsibility; Trust funds; Regulation of financial institutions
**Geographic Names:** United States; US

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39 experts predict the future
Dixon, Mary
America's Community Banker , v 8 , n 7 , p 20-31 , Jul 1999 **Document Type:** Journal Article **ISSN:** 1082-7919 **Journal Code:** SLN **Language:** English **Record Type:** Abstract Fulltext
**ARTICLE REFERENCE NUMBER:**
**Word Count:** 10476

**Abstract:**

Though you may not be ready for the fireworks and crowded hotels and restaurants as civilization approaches a new millennium, it is advisable for business executives to be aware of just how fast business is heading into the future. It seems the new millennium is just cause to roll out big, new bold ideas and inventions. The banking industry is, indeed, part of that craze. That is why for 6 months predictions about the future of financial services have been gathered from some of the key players in the trenches. These 39 predictions from experts making the products and services for the industry and who want to stay in business for the future are presented in 8 categories: 1. internet/electronic, 2. overall, 3. customers/marketing, 4. systems, 5. security, 6. architecture, 7. personnel, and 8. ATMs.

**Text:**

By the time you read this, there will be less than 200 days to the year 2000 and to the final year of the current millennium. If you aren't wildly excited about this prospect (yet), there will be many in the media who will try to make you, at least, somewhat interested. You can put us at the top of that list.

At 215 days and counting until the new century arrives, there were already 1,110 books listed on amazon.com about the new era brought in by the date change. On the same day, a Yahoo! search under "millennium" came up with 806 leads. There are tons of new companies capitalizing on the hype, including Millennium Cafe and Millennium Software. At amazon.com, you can even find a comprehensive millennium store.

Though you may not be ready for the fireworks and crowded hotels and restaurants as civilization approaches a new millennium, it is advisable for business executives to be aware of just how fast we are heading into the future. It seems the new millennium is just cause to roll out big, new bold ideas and inventions. The banking industry is, indeed, a part of that craze.

That's why for more than six months, we gathered predictions about the future of financial services from the key players in the trenches. These are the experts who are making the products and services for the industry and who want to stay in business in the future. We asked them to give us their predictions for the future of banking. We heard from thinkers at companies which make ATMs, design computer systems, design bank buildings, market online systems, as well as from experts in marketing and office

logistics.

Some of the experts tempted fate by looking far into the next century. Wolfgang Dalichau, vice president of NCR Financial Solutions Group, told us about intelligent appliances. He envisions a microwave oven that will one day provide access to online banking, shopping and e-mail. He sees someone in the kitchen cooking a chicken and getting stock quotes off of the same appliance. Several experts predicted talking online banking sites and multi-use ATMs.

There were several bold predictions-like the intelligent microwave oven-but the two themes that stood out were: Electronic banking will be the norm and knowing the customer will be key to success. Competition will be great and the bank that can give the customer what he or she wants will win. All of this will be achieved by embracing technology.

Congress has been playing around with financial services modernization for quite awhile. And some progress has been made. But nothing will modernize and change banking more than new technology. We hope our experts give you a few ideas to embrace.

Internet/ Electronic

CHUCK WHITE CEO

HOME ACCOUNT NETWORK

A new competitive landscape is taking hape, offering exciting opportunities to banks. But if banks fail to seize the day they risk losing ground to other financial institutions. In this new environment, your competitor is not the bank across the street. It's AOL, Yahoo!, Fidelity, Charles Schwab, and maybe Wal-Mart.

The good news is that customers would rather deal with you-Forrester Research indicates that 61 percent of consumers prefer to consolidate financial services with their bank-if you provide the products and services they want. That means offering services on the Internet. By 2002, an estimated 50 million-plus households will be online, and 20 million will be banking online. The experience of banks to date indicates these are the most desirable, profitable customers.

Forward-looking banks have moved beyond posting brochures on their websites to providing transaction processing. We're beginning to see value-added financial services-bill payment, financial planning, estate planning, insurance, brokerage. On the horizon are sites that offer integrated financial services-a "hub" to which your customers will return again and again.

NANCY LANGER VICE PRESIDENT, GENERAL MANAGER M&I DATA SERVICES

Every aspect of the financial services industry is undergoing rapid change, but the transformation caused by advancing technology is stunning. This makes it difficult to envision the future of electronic bill payment and presentment (EBPP). But one prediction can be made with complete certainty: If financial institutions don't embrace EBPP other consumer Internet services providers, such as Internet portal sites, will. And that means financial institutions will have to scramble to catch up.

The fact that industry experts disagree over whether EBPP really is the "killer app" and whether it will attract a mass of consumers to online financial services makes it tempting to sit this one out and to wait for the dust to settle. That is a dangerous position to take. Portal sites such as Yahoo! Finance and Quicken.com are aggressively building brand identity and making headway into the financial services industry with financial products geared to small businesses and consumers. If this trend continues, service providers such as these could become the preferred choice for consumers to receive and pay their bills in the decades ahead. The core issue for financial institutions now, and in the future, is control of the electronic payment process.

JACKIE CUEVAS MARKETING DIRECTOR Q-UP SYSTEMS, INC.

Electronic commerce through the bank's website will allow customers the ability to make secure purchases from online merchants. This capability can take online banking to another level, integrating online shopping with online banking and providing additional revenue opportunities for banks.

Bill payment has been around for some time. But the application that could really push banks to the forefront of the digital marketplace is electronic bill presentment.

Personalized online banking centers could be the next wave in Internet banking design. Through customizable screen layouts, banks can provide customers with the ability to set up a "My Bank" page (similar to the "My Yahoo" pages offered by Yahoo!). This turns the bank's site into a portal and start page for customers. This page would allow users to log in for online banking and access information of interest, such as stock quotes, investment news, sports scores and local news.

Online customer support can help bring online banks closer to their customers. A few online banks are already offering customer service through their website that integrates with their call center or provides realtime chat service. Through call center integration, end-users can click on a " call me" button that automatically requests a call back from a customer support representative. With chat service, end-users can converse with customer support in real-time to troubleshoot questions immediately.

HARVEY SAX PRESIDENT

(Illustration Omitted)

HOMECOM COMMUNICATIONS

Not too far in the future, consumers will log onto their community bank website, and be greeted with a message addressing them personally such as, "Welcome back, Mr. Sax. It is good to hear from you again. Your last visit was on March 15, 2002. You might be interested to know your portfolio of stocks and mutual funds has appreciated 5.1 percent since your last visit. Also your recent activity on our website indicates you may be in the market for a refinancing of your mortgage. Rates are the lowest in 10 years, just click here if you would like to receive a call from our refinancing specialist."

All this is possible today, but tomorrow it will be widespread. Community banks will offer a variety of financial products and services that, today, dwarf even the largest financial institution's ability to deliver. The Internet is going to make comparative shopping for insurance, investments and traditional banking services something that the consumer will demand from their main banking relationship.

As the consumer logs off the banking website, and because he or she is a good customer, a final greeting message will say, "Goodbye Mr. Sax, remember because you are a special customer of ours, Mr. Williams, our president, is available to video conference with you anytime you like. Click here to access his schedule and make a cyber visit."

DAVID W. BRASFIELD PRESIDENT, CHIEF EXECUTIVE SBS

The Internet will be the next century's solution for community bankers struggling to compete in a changing financial landscape. Through home banking websites, community banks can strengthen their ties to business customers and add new sources of income. Partnerships and outsourcing agreements can turn a bank's website into a portal to a variety of alternative products and services. For example, a small business may look to its community bank to collect returned checks and handle other cash management services, such as wire transfers and bill payment.

The bank can also be a source for investment products, employee benefit plans, office supplies, leased equipment, overnight package delivery and other offerings that are provided by third parties but branded to the financial institution. Customers perceive their bank as bringing them this host of value-added services and considerable cost savings.

Products and services can be set up as simple turnkey operations, allowing the bank to deliver the greatest value to its customers with the least strain on the bank's human and technological resources. The bank plays a strategic role of introducing the user to the provider but typically does not touch the transactions and is not responsible for customer service. This makes it vital to select providers that meet the quality standards of the bank.

ROBERT MARTIN CHIEF FINANCIAL OFFICER TEAMQUEST CORP.

Technology is a great equalizer. The declining cost of computers and easier access to the Internet provides community banks with a wonderful opportunity. They now have the chance to level the playing field that has for so long been dominated by large regional and moneycenter banks. Community banks can now engage in electronic business so that they appear no different to customers than a high-tech institution. The Internet makes it possible for any bank with a smoothly functioning network of servers to give customers instant access to their accounts; this could include bill payment information, brokerage services, money transfers between accounts and more.

However, with this opportunity comes risk. Once community banks recapture more local customers they will retain them only if they can provide optimal service. If the bank itself fails to keep its system operating smoothly, or if it fails to access data as quickly as its new customers have come to expect, the competitive advantage affordable technology offers will vanish.

DEBBIE SMART GENERAL MANAGER COMMUNITY BANK GROUP, POLITZER & HANE THE WELLNITZ GROUP

While the cash management industry has enjoyed moderate growth over the years, community banks have only recently realized the benefits of electronic cash management services. With the migration from mainframe to workstation to browser-based systems, community banks have emerged as a competitive force in the cash management arena.

The introduction of PC-based cash management systems opened the door for community banks and their target customers. Community banks supported the cash management needs of their small business customers with affordable, PC-based systems and user-friendly software. However, labor-intensive support issues, including software installation, product upgrades, and technical support, were obstacles to widespread cash management growth in the community bank market.

The emergence of the World Wide Web has changed the way community banks deliver cash management services to their customers. Customers can now access electronic banking services via industry-standard browsers, and software installation, distribution and support are eliminated. The time and money that community banks used to allocate to support issues can be spent more productively on activities that attract new business accounts and expand customer relationships.

STEVE GUTHRIE

DIRECTOR OF MARKETING COMMUNICATIONS TELOQUENT COMMUNICATIONS CORP.

Imagine the exceptional speed and convenience of offering customers the ability to talk face-to-face with a mortgage banker, consumer specialist, private investor counselor, private banker, commercial loan officer, or other banking specialists without having to be in the same office together.

Over the past few years, competition in the financial services field has created the need for banks to offer a broader range of services to all their customers and driven the requirement by customers for more convenient ways to get financial services. Previously, video banking services for linking customers to financial specialists via a video kiosk in a branch location or in a supermarket was only for the larger, more recognizable banks.

DAN WELBAUM SENIOR VICE PRESIDENT FISERV ORLANDO

It's tough to try to gaze into a crystal ball and summon up a good guess about the future. Technology is transforming our lives more rapidly than at any time in history, and technology itself is exploding with useful innovation at an exponential rate. For example, even the wisest prognosticators of the early 1970s failed to foresee the development and growth of the personal computer. In the 1980s, only an obscure few envisioned the World Wide Web.

One of the most powerful forces that we foresee driving the future of lending is the constantly increasing effectiveness of communications technology. Although we're unlikely to see fully computerized loans until

legal departments can cure themselves of their paper addiction, the rise of digital cellular and satellite-based voice, data, and video communication will ultimately result in almost instantaneous lending-even for mortgages. In the nottoo-distant future, we envision financialservice providers (not just banks) which operate efficient, all-digital "contact" (not just "call") and processing centers using highly sophisticated processing, underwriting, and closing software.

The Internet will become a dominant factor in mortgage-lending technology by the year 2010, with as many as 30 to 40 percent of all mortgages being originated and closed via the World Wide Web. We envision a kind of mortgage eBay, with borrowers securely posting their loan needs on the web and lenders bidding for their business. Increased competition and efficient Internet-based delivery systems (including appraisals, title searches, and insurance) will drive down the cost of doing business and make mortgages more affordable and convenient than ever.

GREG HAMILTON

SENIOR VICE PRESIDENT OF UNDERWRITING FIDELITY & DEPOSIT COMPANY OF MARYLAND

The year is 2025. The Dow is poised to break the long-awaited 25,000 milestone.

The concerns over the year 2000 millennium bug, as it was known at the eve of the 21st century, are a distant memory. Planes continue to fly, electricity continues to flow, and of course, banks continue to provide valuable financial services to its commercial and retail customers.

What has changed is the standard method of delivery of banking services. Electronic commerce is the primary means of exchange of goods and services between parties. The entire gamut of financial services are accessed electronically. Customers receive and pay bills, apply for loans, and receive the disbursements from the comfort of their PC workspace. All deposit and withdraws are made electronically. The banking customer has 24/7 access to his bank and banker. The ATM, the rage of the late 1900s, has taken on a new meaning. Every banking customer now has an electronic teller (ET) card that fits into his or her desktop, note book or handheld combination telephone-computer. The ET card is the key to e-commerce in 2025. It can even be used to phone home.

Overall

WOLFGANG DALICHAU VICE PRESIDENT

NCR FINANCIAL SOLUTIONS GROUP, THI AMERICAS

There's a new world of financial services on the horizon. It's a world where computing and communications will converge to redefine the financial services industry, where the boundaries between financial institutions and retailing will blur even further. It's a world where information-rich consumers can conduct their financial business through their microwave ovens or computerenabled clothing accessories.

Banks will tap new technologies to build closer relationships with their customers. Already under study are webenabled ATMs that link the world of entertainment with the world of finance; a new generation of electronic money that allows both transaction and communication on the same medium; and innovative solutions to make banking more pleasurable. NCR's Knowledge Lab, for example, has begun developing technologies such as an "electronic soap opera" - with an interactive character called Rei who will guide consumers through a range of financial issues. We've even created a Microwave Bank, an intelligent appliance that provides access to online banking, shopping and e-mail...while it heats up dinner.

Changing technology won't be the only challenge. Tomorrow's financial consumers will be different as well. Theyand their changing lifestyles-will demand new, more personalized connections to their banks. The result: financial services providers will have to gain greater insight into the relationship between consumer lifestyles and technology if they expect to thrive in tomorrow's new world of banking. The world is not waiting for the wired generation; is on its way.

AMY RADIN EXECUTIVE VICE PRESIDENT, CHIEF MARKETING OFFICER DIME

BANCORP

Former Comptroller of the Currency Eugene Ludwig has stated emphatically that in the next century, the banking industry will be "unrecognizable" based on today's standards. Those are strong words, but not an over-statement when you consider that the vast majority of banking customers in the year 2050 haven't even been born yet.

That said, The Dime has been in business for 140 years, and while we've changed dramatically over that period, our best features have remained consistent. It's an understanding of our customers' lives and businesses, and an ability to anticipate and meet their needs that has sustained our relevance for so long. In short, our customers have trusted us with their business for more than a century, and we fully expect we'll still be earning that trust in 2050 and beyond.

Still, considering the pace at which technology is changing the world today, it is hard to fathom the role that it will play for Dime customers, both individuals and businesses, in 2050. They will conduct almost all of their transactions involving money online-be it researching and buying stocks, receiving and paying bills or applying and getting approval for mortgages and other financing. A baby born today may grow up never needing to set foot inside a bank branch. She will sustain a single banking relationship no matter where she moves. She will have access anytime and anywhere not only to her money, but to expert financial consultants and a vast inventory of information and products that will help her make the best decisions for her lifestyle. She will feel safe conducting all her business electronically, and will combine access channels-perhaps using her phone, computer and mobile electronic devices as ATM and point of sale points. With all this at her fingertips, she will be the most savvy customer in history.

JAY KASSING PRESIDENT, SALES Rc MARKETING THE CENTRAX GROUP

Will Rogers once said that there have been three great inventions since creation: fire, the wheel and banking. Community banks will continue to have a great impact on our way of life. And, in the world to come, as consolidation continues among financial institutions, it will be the community banks that provide the thread of stability in an otherwise uncertain financial environment.

Is there a relationship between further consolidation of this industry and an increase in bank startups? Yes. Look for new community banks to spring forth, splintering away the value of the newly merged, and providing the service and customer relationships that the market desires.

In the near future, advancing technology will allow community bankers the ability to integrate true customer relationship management practices faster, more completely, and therefore more effectively than the larger institutions. Instead of focusing on building the ideal mousetrap (like larger institutions), community bankers will focus on enabling the technology available. This will allow community banks to further their lead in providing common sense, good-natured banking.

JIM CLARKE CLARKE CONSULTING

It is difficult to envision the future for community banks, but a couple of events that occurred in 1998 ought to suggest to us the possibilities. In April, Citicorp and Travelers merged to create Citigroup, and later that month Bank of America merged with Nation's Bank to form a national mega bank. Citigroup is an all inclusive financial service provider for household and business customers. Is this the model of the future financial services firm? A conglomerate offering loan, deposit, and other financial services to middle class and affluent households; facilitating the needs of small business, and providing sophisticated financial advice to major international corporations-all within the same holding company. This sounds intriguing, but I do not believe this is the model community banks will need to emulate.

The Nation's Bank, Bank of America merger is the first test of nationwide branching. There are likely to be more of these national combinations after Y2K is resolved. This model is dependent on economies of

size, and if successful, will be a challenge for community banks. The nation spanning paradigm requires massive data collection, and cheap telecommunications to slice and dice the market, but to be cost effective, much of the delivery will need to be impersonal. We will have five to 10 nation-spanning banks in 2025.

Forward-thinking and adaptive community banks will be able to replicate much of the marketing sophistication of the mega banks. The successful community bank in 2025 will offer all the products and services that fit the profile of their customers, and a sales force that is rewarded for profitable synergism. The success will come from the ability to add a flexible personal touch, and charging for this convenience. Serving the customer requires knowing the customer-true today and true in 2025. Knowing the customer is the advantage in community banking.

MARTIN COYLE VICE PRESIDENT PROCESSING SERVICE CENTER

Global consumer power will accelerate in the years to come. Although we have come a long way in the challenge to serve the needs of financial consumers, technology and competition will continue to provide customers with greater options, which they will seek and find.

Sub-prime lending is one clear example of how consumer voids are filled. Borrowers with impaired or high-risk credit have found a viable outlet for their credit needs. Sure, there have been bumps in the road, as with any new idea, but the service lesson is that every unsatisfied consumer needs, seeks, and eventually finds, a service outlet to fill their financial needs.

Meeting the ever-growing demands of financial consumers will require a set of market reactions which traditional financial service providers struggle to embrace. Tomorrow's drill will be the same as today's: Anticipate oncoming consumer needs, flex our resources to accommodate them, and charge ahead of the competition to gain an advantage.

CALVIN D. JOHNSON INDUSTRY MARKETING MANAGER BANKING & FINANCIAL SERVICES BELLSOUTH BUSINESS

What will community banking look like in 2020? Household banks, financial service auctions and e-currency may be the norm in as few as 20 years.

Mergers and consolidations will likely whittle the number of banks down to fewer than 50 worldwide in the next 10 years. But that number may grow drastically again by 2020 as every household operates its own virtual bank from the comfort of home. This scenario creates the ultimate community bank-located right in a customer's living quarters. Customers may be able to conduct transactions from downloading e-cash to a stored value card, to executing **investment** or purchase decisions at their **discretion** of time, place and medium.

Financial services may transition to commodities and could be purchased via auction over the Internet. For a mortgage or car loan, customers will receive the lowest interest rate on that loan by participating in an "auction" for the best deal. Financial service organizations will compete for business with minimal effort required by the customer.

And finally, banking in the future will most likely mean the disappearance of all country-specific paper currency, replaced by electronic currency accepted worldwide. All transactions will be conducted via some digital format, with the exchange of monetary value occurring online, realtime at the push of a button or through smart card transactions for those few remaining face-to-face business encounters.

While it's challenging to speculate on the future of community banking, don't be surprised if instead of talking to a teller, you talk to your computer-and it talks back.

Voice-commerce (or v-commerce) will replace e-commerce, and convenience banking will occur wherever a customer is at any particular moment.

MATTHEW P. LAWLOR CHAIRMAN, CEO ONLINE RESOURCES & COMMUNICATIONS CORP.

The end of banking as we know it is not around the millennium corner, but there's no question that a new customer will dominate by 2020. She (yes, some of us guys know who's in charge) will rarely, if ever, set foot in a bank branch but will want instant access to her money and to move it in real-time. Using voice-activated, hand-held wireless appliances as well as computers, she'll buy financial products and services from banks and their competitors. Aided by artificial intelligence programs, she'll move money almost seamlessly anywhere in the world in and out of securities, fixed income accounts, insurance policies and other packaged financial products. The ATM and credit card will converge into a single bankbranded smart card that will also be her security key to access services.

In 20 years, the language of the Internet, TCP/IP, will have become a worldwide standard for all communications. Telecommunications companies will bundle voice, data and broadband services and charge consumers by the minute, forcing business and service providers to offer free digital 800 numbers or extranets. Many banks will be part of financial service companies, selling virtually all financial services. But so will nonregulated competitors. And the focus won't be on high-tech, which will be a given, but "high-touch," making the experience painless, even enjoyable, with high quality customer care. Affordable global communications will make the customer, not the banking office or branch, the center of her financial universe. Banking firms will add value as financial information brokers and providers of cyber space real estate that offer a consolidated, complete picture of consumer options as well as the technologies that allow her to take instantaneous advantage of those options. Is their a role for the community bank in the global village? Definitely. They say all politics are local. So is banking.

GERI FOREHAND PRESIDENT EXPRESSDATA CORP.

Banking in the future will be exciting. We believe banks will be facing many of the same issues they are experiencing today. Consumers of banking services will have more choices, core deposits will continue to be difficult to acquire in order to sustain growth, fee income will substantially impact overall profitability, and successful banks will improve performance by leveraging the power of information.

Community banks will face a number of challenges over the next several years. The areas of change we find most compelling will occur due to the accelerated exchange of information. Commercial and retail consumers will maximize returns by moving funds electronically from one deposit or investment vehicle to another. This will create pressure on core deposits and increase the significance of alternative funding and the national CD market.

The costs associated with internally developed products will become prohibitive, and organizations with the capital and expertise to develop enhanced banking products will seek to leverage the relationship belonging to the community banker. Community banks, in an effort to protect their customer relationships and improve fee income, will offer more products and services from third parties. Competition will intensify and performance improvement will become paramount for the successful community bank. The Internet will bring management tools to new levels. Online, real-time capabilities for asset liability modeling, loan processing and participation, and the purchase of issue specific expertise will be routine.

DAVID GLENN IBM INDUSTRY EXECUTIVE (BANKING, FINANCE AND SECURITIES) IBM SMALL & MEDIUM BUSINESS

In coming years, community banks will be one-stop shopping locations for a wide range of financial products and services. Consumers, ever pressed for time, will do the bulk of their banking from their home computers, yet they will expect and receive personalized, firstname service on those rare occasions when they venture out to the neighborhood branch. When they arrive, they'll be offered new life insurance because of the pending arrival of twins, a home equity loan to help smooth things over while mom's on maternity leave, or a favorablerate mortgage on that new,

bigger house.

By anticipating the customers' needs, bankers will be ensuring a continued relationship, and strengthening their own future.

Dual forces are reshaping the way community banks do business and how well bankers deal with these trends will determine the rate of future revenue growth and, ultimately, the bank's very existence. No matter how bankers approach consolidation and convergence, expect technology to play an ever increasing role.

As banks continue to buy other banks, and, in essence, new customers. Forwardthinking bankers will position their institutions to either do the acquiring, be acquired, or remain independent. And the key element driving each strategy will remain how the bank retains, attracts and interacts with its most profitable customers. That's where technology comes in.

Multiple financial products, including savings, checking, consumer loans, business loans, brokerage, investments and insurance will increasingly fall under one roof, and often rely on their own software and databases. As a result, it will be nearly impossible to mine useful customer information on a timely basis. The successful banks in the future will have recognized this dilemma and reacted using a concept called "business intelligence." Let technology be your competitive weapon.

GOVIN MISIR CHAIRMAN AND CHIEF EXECUTIVE SLM SOFTWARE INC.

Banks are always looking for new ways to cut costs, increase revenues, and provide better customer service by offering new products. It sounds like a tall order but the solution already exists: ecommerce technology.

Soon transferring funds and getting a car loan will be commonplace from a home or office PC. Forecasters predict that one billion PCs are expected to be on the Net by 2005 and web transactions will be in the billions of dollars. This is dramatically changing the market landscape: How we think and how we do business. And the banks are leading the way. Ecommerce technology is attractive to both the banks and consumers. For the banks, it means improved operating efficiency and new sources of revenue. For consumers, it delivers greater convenience for anytime, anywhere, anyhow banking.

For these reasons, e-commerce will continue to play an increasingly larger role in the banking industry. Having said that, a completely wired and cashless society is farther away than we might hope. Consumers want convenience and flexibility but they still need human contact.

Traditional branch banking is expected to be around for many years to come, but will take a different form. Today, branch banking is more transactionbased. Twenty to twenty-five years from now, it will be more sales-focused. Transactions will be performed through electronic channels, while the branch will be centered on selling customers new services such as mutual funds, insurance and financial planning. Consumers are already accustomed to using the ATM for their daily transactions. Credit cards are everywhere. Soon, too, will be debit card machines (that simply require a banking card to operate).

By providing customers with the broadest range of traditional and electronic financial services at the best price, today's banks are striving to provide the best of both worlds to keep customer loyalty and satisfaction high.

CALVIN D. JOHNSON PRESIDENT JOHNSON & ASSOCIATES

The following transcript is excerpted from a recent broadcast from the ABC (Andromeda Broadband Constellation) News Department. This broadcast was received throughout the Milky Way Galaxy over a variety of GalaxyComenabled media, including DT Inc.'s Wristband Personal Communicators, Jetson Corporation's Integrated Transport Windshield Monitors, and REM's Subliminal Sleep-State Storage Systems (pioneering the latest in Saturn S5 technology). GalaxyCom is the universe's largest telecommunications provider and is the result of recent mergers of AT&T, MCI/WorldCom, Sprint, and the few remaining Regional Bell Operating Companies brought back together during a heated shareholders' proxy battle championed by the spirit apparition of Judge Harold Greene.

Good evening, I am cryogenically preserved Hugh Downs, and this is 20/20not just the television news program, but also the year 2020! Tonight we want to take a look at the some of the recent developments taking place in the intergalactic financial services industry.

First, from Planet Earth, now popularly referred to as Helios+3, tomorrow will bring us the introduction of the first truly global currency standard to be used worldwide. Following over two decades of successful assimilation of the euro throughout economic systems in the Western Hemisphere, The World Bank will be rolling out the much-heralded Terra. Unlike all previous forms of monetary units, the Terra will exist in only electronic form, ranging from being stored on personal valuation cards (PVC's, popularly called Plastic) to cyber procurement units (CPU's) for Internet-based electronic commerce. In the United States, the Terra will replace those dirty old paper dollars used in mattress stuffing, thus forever severing all ties to the historically debated gold standard of the previous millennium. Counting on his fingers, Fed Chairman Alan Greenspan, a fellow cryogenarian, enumerated 17 ways that digital currency would enhance the payments systems and concluded that Woodrow Wilson could have had a lot more impact utilizing 21st century biotechnology developments.

In a related story, the U.S. Treasury Department finally revealed that Fort Knox never really existed and that the past 50 years of unprecedented economic growth had been fueled by the myth that the U.S. government really held gold assets to back up its paper currency! "We sure fooled you guys into thinking we had any control of monetary policy," chuckled Mr. Greenspan as he boarded his personal space shuttle for an extended vacation at his resort on Jupiter.

Finally tonight, we have news on a study about the evolving efficiencies of the banking system. From a universe of over 15,000 U.S. banks in the 1970s to less than 20 worldwide banks just a few years ago, the industry has now embraced both technological and regulatory change that has increased the number of financial institutions to almost 500 billion! Yes, now every household on this planet and elsewhere possesses the capability to operate its own bank branch in the comfort of its own living quarters. Financial services are purchased via auction over sites enabled by technology from GalaxyCom Internet Banking Services Inc. Community banking has indeed survived, and has taken its ultimate form-a community bank charter in every household, thus recognizing that personal one-to-one customer service, not the commoditized banking products offered universally, is the true differentiation factor in today's banking world. Community banking really does mean convenience after all. Thank you for watching, wherever you are. For 20/20, this is Hugh Downs.

Customers/ Marketing

RICK RoY VICE PRESIDENT, GENERAL MANAGER M&I DATA SERVICES

Many financial institutions know that customer relationship management is crucial to the future of their organizations. Detailed customer information gathered from transactions, as well as other internal and external sources can provide financial institutions with a competitive advantage. These organizations are striving to gain an understanding of their customers-their likes, dislikes, needs and wants. Building better customer relationships in the future requires a decision support engine and a customer information system in the present. A decision support engine, comprised of a data warehouse, plus reporting and analytical tools will help drive better customer information. The key is for financial institutions to shift from a product focus (i.e. checking and savings accounts) to a customer focus, with centralized customer information.

But what good is a crystal ball when a person cannot read the portents? Similarly, data is useless without reporting and analyzing capabilities. Reporting tools are important to segment customers according to financial institution criteria. For example, the organization should be able to write a report identifying all customers between 40 and 50 years old, who have a checking account and a line of credit, but do not have a home equity loan. Identifying this information results in targeted,

effective direct mail and telemarketing campaigns.

Sophisticated customers of the future won't tolerate multiple mailings that lack understanding of their needs. Financial institutions must use householding to improve customer satisfaction and reduce costs.

Current banking trends predict increased data warehouse usage for additional marketing opportunities. Plus, the next two decades will reveal new tools that enable banks to develop more sophisticated consumer models, better understand customer needs and integrate marketing efforts for the entire life cycle of the customer relationship.

PAUL FIORE FOUNDER DIGITAL INSIGHT

The bank of the future is already here, using target marketing to lay the foundation for future **profits**. Already entering the marketplace are online software engines that can implement one-toone marketing strategies based on individual customer preferences, transaction histories, and permission profiles. In addition to traditional banking products, banks will be able to use these engines to sell an increasing variety of revenue-generating financial products, including tax preparation, brokerage, and insurance services.

Banks will also be able to generate additional revenues from the sale of website advertising, or by marketing selected non-financial products and services from other providers for fees or commissions. Online banking is a definitive example of a "sticky" application, one that gets customers to return repeatedly. Our sample of more than 350,000 online banking customers indicates that a bank's Internet customers log on about 4.6 times each month. Yahoo! would die for that kind of loyalty. And loyalty is a great advantage for a website holder, one that can be converted into hard revenues.

These new target marketing capabilities will enable community banks to act as financial web portals for their customers, delivering a constantly increasing range of products to meet a growing **share** of each customer's individual needs, and transforming a bank's Internet banking operation from a cost center to a **profit** center.

Systems

TOM SHEN PRESIDENT SOFTWARE DYNAMICS INC.

The future of banking will be shaped by the interplay of three key factors: the evolution of technology, the revolution of financial services and the ever-changing expectations of customers. Responding to pressure from these factors, institutions surviving through the new millennium will do so by the exploitation of one key advantage, the synergistic use of existing and new delivery channels. These institutions will create the ability to better target specific sales opportunities, improve delivery of specific sales messages, and create value through customized delivery of products and services.

This contributes to dramatically improved customer service, resulting in complex but loyal relationships with benefits to both institutions and the customers they service. With advanced delivery mechanisms and targeted customer relationships, the convergence of banking with other industries including insurance, brokerage, supermarkets, online and local shopping malls, and travel agencies will result in integrated services institutions of all shapes and sizes.

Key to this success will be the implementation of customer relationship management databases, continuous feedback customer contact mechanisms, and an integrated channel management mechanism that allows consistent, maintainable delivery of services and information uniformly across all the channels. The payoff is a common sales and service proposition over all financial channels.

In 1999, we have the Internet, the promise of web banking, biometrics, computer telephony integration, voiceover IP, data warehouses, mergers, convergence, non-bank competitors, and Net-savvy, five-year old future customers. All of these things will contribute to the shape of things to come, but the essence of the future of banking is distilled, not from star war's technology, but from focus on the customer relationship.

THOMAS MCALLISTER, CHIEF OPERATING OFFICER AMERICAS SYSTEM ACCESS

The increased reliance on Internet commerce and the industry move to web-enabled computing on both the Internet and corporate intranets will be the major change drivers, along with improved customer resource management in the financial computing industry. Banks faced with both the need to compete and to control costs will change their existing tactics of wrapping software around their legacy monoliths and move to scaleable, web-enabled, e-commercecapable, easily changeable, relational, integrated systems which have in their basic design scheme a front to back (straight through) and CRM processing capabilities.

ROGER PETERS SENIOR MANAGER INTEGRATED TECHNOLOGY SOLUTIONS GROUP

America's community banks have invested thousands of hours and millions of dollars preparing for the year 2000-yet many will fail to realize a longterm return on their once-in-a-lifetime investment After Jan. 1, 2000, banks can either maximize the benefits of their Y2K planning process, leveraging their research for long-term use-or relegate their plans to the archives, gathering dust as a due diligence defense in the case of any future Y2K litigation.

Y2K planning has helped institutions develop critical skills in technology planning, software testing, system implementation and project management. Detailed systems inventories have been assembled, new systems have been implemented and staff members have gained a much clearer perspective on technology's impact on their business and customers. The industry has never had a better technological position to capitalize on current and future business opportunities.

Rather than disbanding the Y2K Committee and archiving plans, banks should focus on improving service quality and efficiency to enhance the institution's competitive position. Projects such as Internet banking, enhanced customer service systems, imaging and others have been delayed or suspended to achieve Y2K compliance. Banks should now focus their resources on developing strategic technology plans that span the next three to five years to take full advantage of new systems, updated applications and expertise.

The systems inventories, standardization and cooperation between departments that were so difficult to obtain and implement will rapidly become outdated -unless they are maintained through ongoing planning. By developing longrange technology plans, banks can effectively use these resources for planning, budgeting and quality enhancement purposes.

JOHN SAELENS SENIOR VICE PRESIDENT UNIFI PRODUCTS GROUP

Hiccups are disruptive and annoying, so most of us will try nearly anything to get rid of them. We'll hold our breath, we'll scare ourselves, and if that doesn't work, we'll stand on our heads. Creative temporary solutions all-but isn't an outright cure what we're really after?

Undoubtedly, E-trade would like a remedy for its online hiccups. After a major software malfunction in February, E-trade's website crashed three times, leaving investors unable to buy or sell stocks for four-and-a-half hours. Now Etrade faces a class action lawsuit. Similarly, The Wall Street Journal's interactive edition was unavailable to some of its 266,000 paid subscribers in April because of a glitch with its computer system. Dissatisfied subscribers were left to look elsewhere for their news.

Hoping to avoid such pitfalls, mortgage lenders are searching for a robust Internet technology solution that comes equipped with a hiccup vaccination-one that protects their ability to satisfy customers. Key to this objective is finding an origination solution that is able to handle high transaction volumes, while providing the level of automation required to deliver loans quickly.

Despite the hiccups, a research study projects that $60 billion in mortgage originations will occur online in the year 2000 and $250 billion by 2003. Therefore lenders must recognize the need to position themselves to handle high transaction volumes.

Response is also critical. Many of today's online mortgage sites simply gather data and pre-qualify applicants, generating a backlog of

inquiries and loan processing and underwriting tasks. Users of these sites have actually experienced a lengthening in the time it takes to close a loan, generating a great deal of client dissatisfaction.

While multi-lender sites offer lenders an e-commerce business solution, it will be the marriage of robust technology solutions with these sites that will provide a level playing field for lenders of all sizes. The key will be for lenders to investigate the technology used by multi-lender sites to ensure that it is capable of supporting their origination business in the manner online customers will expect.

ERIC BURNETT PRESIDENT, CEO IA SYSTEMS

Automation will shape the future of community banking, changing the current, staid process of lending money to consumers into a banker's field-ofdreams. Using automation technology, bankers will be able to handle more loans more quickly, at lower risk, and with lower costs.

Lenders will increase loan volume as automation streamlines the loan application process by allowing consumers to submit data and applications by themselves via the web. Underwriters will then have instant access to every piece of information that impacts a loan approval decision, and all lines of consumer lending will support fully automated processing. Better decision support tools and re-engineered workflow processes will further lower the cost of lending.

Risks will diminish as lenders add credit scoring to augment the traditional credit bureau credit score. Automation will further maximize profitability by guiding a loan through its stages-automatically pulling credit reports, running scoring models, pricing the loan based on credit risk, and then underwriting the loan.

As the entire business process embraces automation, lenders will realize improved access and quality control, which will lead to lower costs. Automation will eliminate the volumes of paper and folders early in the loan process, replacing them with a seamless, paperless, costeffective, end-to-end customer-focused solution. These reduced costs will be passed along to increase dealer and consumer incentives, making the future community bank more competitive. The important thing to remember about automating for a banker's field-of-dreams is; if you build it, they will come.

JAY DEWALT, DIRECTOR, STRATEGIC MARKETING CHUCK BRASINGTON, DIRECTOR, SOLUTIONS MARKETING UNISYS CORP.

Today, we are seeing a 33 percent annual growth in spending on imaging technology by the U.S. banking industry. Given its dramatic impact on cost reduction, operational efficiency, customer service and competitive differentiation, this investment is hardly surprising. But, what about the future?

Imaging is rapidly becoming simply another tool in the bank's armory for delivering optimum customer service. Banks won't buy discrete imaging solutions to perform independent functions. Instead, the focus will be on cohesive work flows and the seamless integration of people and solutions to generate a single, consistent view of the customer. So, regardless of where contact is initiatedvia teller, mail, call center, Internet or home PC-the customer receives highly responsive, timely and accurate service.

With their ability to capitalize quickly on technological advances, community banks will redefine customer service through in-depth knowledge of the customer. This will be achieved via increased use of the Internet-which also increases geographical reach-and the seamless integration of all the bank's communications channels.

Imaging-whether for documents or payments or signatures-will continue to bridge the information gap. Interbank payment is currently being piloted. Imaging payments at source is now a reality. And, we could certainly see the advent of pocket devices-with inherent imaging capability-capable of handling all our banking requirements. And, as far-fetched as it may appear, we may even see the end of paper in banking!

Security

BOB COFOD PRESIDENT BANKDETECT

The stars of the new millennium light the way to mind-boggling changes, but one thing is for sure: the black holes of fraud and abuse will absorb increasing amounts of our financial resources. The houses of both domestic and international gangs are organizing themselves like planets orbiting in concert around the growing bright **profits** of the crime star.

White-collar crime moves with increasing freedom through our financial industry, while the deterrent value of our justice system fades like the tail of a comet passing into darkness. Seeking order in the universe, all governments will attempt to palliate the diseases of money laundering and terrorism through added regulations. Amid wide spread social evolution, banks will find new opportunities in the ubiquitous high band-width information environment of tomorrow.

But the crime star will be equipped with equal information, better technology and a cash-filled, tax-free larder to fund its attacks on the world's financial vulnerabilities. Counterfeit will abound and new electronic threats will attack both privacy and security. Banks will fight back with loss prevention technology offering sophisticated automated analysis and decision support. Improved biometrics will aid customer identification without threatening privacy. Automated document identification and verification will be modernized. But vulnerabilities will remain. Community banks will be increasingly popular targets as large banks build prevention processes and criminals seek easier pickings.

Fraud and abuse has been a growing problem through good economic timesa downturn could bring unprecedented losses.

MARC GOODMAN, SENIOR DIRECTOR OF MARKETING F5 NETWORKS, INC.

The Internet holds the promises of simplicity, flexibility and an economical way to deploy applications through intranet and extranet e-commerce sites. The number of financial organizations integrating web-based applications within their business systems is growing sharply, and networks must be fortified to handle an onslaught of potential new users-internal and external to the organization.

Clearly, financial businesses must reevaluate their network security strategy in order to adapt to this open computing environment. Total security for network connections, applications and systems is required. This infrastructure protection will insure the prevention of unwanted individuals from causing havoc and potentially crippling a website.

Some traffic management products contain built-in features designed to heighten network security and provide protection for your servers and devices against common attacks. Business-critical financial sites can use these products to load balance and securely manage a set of transparently configured firewalls, proxy cache servers, and content or mail filter servers.

As for the future, it's important to choose Internet traffic management products that let your infrastructure grow as your business grows, one server at a time, as fast or a slow as needed. This also has the secondary benefit of extending your investments in equipment already owned. Furthermore, we see the importance of companies that offer total open-ended solutions for the Internet-not only for servers, but appliances for networks, content and applications as well.

Architecture

DEAN WILCOXEN ARCHITECT HBE CORP.

The bank of the future will be surprisingly familiar. People will still want a sense of place, where they can feel comfortable conducting business. Technology will continue to improve exponentially, but the environment where the customer banks will still need to inspire trust and confidence. Here are some things we've noticed that demonstrate the bank of the future is evolving faster than ever.

Increasing the number of "relationships per customer." It is not enough to offer the customer basic services. To stay successful, banks have to develop an understanding of their customer. Bank designs will encourage customers to perceive the facility as a destination-a place to meet and

gather information.

Improving ease of access. Successful banks have to be consumer-friendly, offering ease of access. Ease of access does not refer exclusively to the physical layout and location of points of entry. The perception that a building is easy to access will be encouraged in the minds of the customer, putting the perception in place even before the customer gets to the bank.

Head-on drive-ups with two-way visual communication technology will allow the customer to see the teller and the teller to see the customer. Face-to-face technology will personalize drive-up service.

Bank customers will want it all. To be able to park close to the entrance, to have handicapped access, to have a level grade to walk and clearly defined entrance points.

Banks will realize that it's not the basic menu of bank transactions that benefits the bottom line, it is the sales of the bank's other services. Ten years ago, the focus in bank facilities was on the transaction. In the future the focus will shift to merchandising and creating opportunities to crosssell bank services. The design of the bank will incorporate time-tested retail merchandising principles, like sales zones, sight lines and watermarks to guide the customer through the space.

Due to staffing pressures, banks have to learn to provide better service and an expanded menu of products and services with fewer people. Cross training will be the answer, blurring the boundaries between bank employees' job descriptions. In the bank of the future, all bank employees will perform a variety of duties as customer service representatives. And trends like teller cash dispensers and express lanes and ATMs in the teller line will help tellers more quickly serve customers withdrawing cash or cashing checks, which will in turn speed up transactions and decrease the number of tellers necessary to serve the bank's customers. Cross-training's implications for bank design include generic workstations replacing walled-in loan offices and a lobby plan that will integrate, rather than separate, the bank's functions.

Although banks will continue to add cutting-edge technologies to serve their customers, the need to build bank facilities that foster a sense of place and offer customers personalized service will be the most important element of the bank of the future. The banks that can satisfy customer demands for service and technology will be the success stories of the next millennium.

JIM GIVAN PRESIDENT, CEO DESIGN BUILD CONCEPTS

In the 25 years that Design Build Concepts has been designing and building banks, we have seen an evolution in customer practices that has affected bank functions and impacted facility design. As compared to the mid 70s, today's banks have more drive-up teller lanes, fewer walk-in teller stations, ATMs, and an increasing need for loan offices as financial services expand. There has also been greater emphasis on concierge and customer service representative (CSR) desks, staffed by cross-trained personnel.

Just as the automobile affected the bank, so will the Internet. Customers will perform routine transactions on the PC, and the walk-in teller station as we know it today may become extinct in the next 25 years. Yet, I believe that Internet banking will not eradicate the need for traditional facilities for both consumers and commercial clients. More than baby boomers, the generation Xers are interested in self-sufficiency; saving for retirement, planning for their children's college education. They desire to own their own business, be their own boss. These consumer behaviors will necessitate a personal banking relationship.

Trends of the last 25 years indicate that banks of the future will continue to be bricks and mortar, conveniently located to their markets. Drive-up services will remain strong. Inside, personal bankers sitting at desks will replace tellers, and they will be surrounded by a greater number of private offices for fullservice financial advisors. Trends in bank usage will evolve, not radically change, until we adopt a totally electronic or

cashless society.

PETER DIXON SENIOR PARTNER LIPPINCOTT & MARGULIES

The future of banking will not be "either-or," in which financial institutions will decide to be either all electronicbased or attempt to exist only with their traditional bricks and mortar. As Nicholas Negroponte, the cyber-futurist, has predicted, the future will be "both-and," where financial services companies will take advantage of both the convenience and cost of delivery advantages of Internet and telephony-based transactional banking and employ multiple distribution channels, including branch facilities, for a converged financial product offering. Additionally, specialized retailing methods such as, remote kiosks, off-premises ATMs, and even door-to-door consulting, will target and align profitable customer needs with the right marketing and merchandising approach.

Overall, it will be the strongest financial service brands that control the future; brands that clearly define what they stand for and deliver on that promise. From global, technology-driven megabanks, to specialty niche players (including locallyfocused community banks), the banks that develop a clear and strong identity and represent a resource for making their customers' lives better will be the ones that **profit** and thrive.

Personnel

LYNN TAYLOR VICE PRESIDENT OFFICETEAM

How will your business skills measure up in the new millennium? If you're a good negotiator, an even better listener and communicator, and are proficient with advanced technology, your career prospects in the future workplace are bright. On the other hand, if your interpersonal abilities could stand fine tuning, now is the time to take action.

The results of a new research project conducted by our firm found that by 2005, technology's transformation of the workplace will not only place an ever-increasing premium on technical abilities, but it will also put employees' people skills to their greatest test yet. In fact, it could well be your interpersonal and communication skills that make or break your career in the office of the future.

OfficeTeam gathered the opinions of a variety of technology and workplace experts, commissioned independent research and interviewed our internal offices regarding client and candidate trends in order to gain realistic snapshot of the office of the future. A common theme throughout all of our research was that as technical advances enable us to communicate more rapidly, more often, and with greater numbers of people simultaneously, communication, diplomacy and problem-solving skills will become a necessity. A survey of 1,400 chief information officers commissioned by our firm supports this conclusion: 78 percent of respondents said that by 2005, the increased use of technology would require workers to communicate more effectively and articulately.

The "soft" skills identified as most important to career success are reflected in the acronym, PEOPLE and include expertise in problem solving, ethics, openmindedness, persuasiveness, leadership, and educational interests. Unfortunately, because of their intangibility, mastering these skills can be even more difficult than acquiring technical expertise. The key is to become a keen observer and allow experience to be your guide.

Some additional suggestions. Watch closely how successful people apply their expertise in diplomacy, negotiation, and conflict resolution in a variety of situations. Seek a mentor inside or outside of your company. Hone your writing and speaking skills. Volunteer for leadership positions within your company or in the community. Pursue educational options such as Internet-based training and research, user groups, professional seminars, and business and trade articles by experts in your area of development.

MICHAEL J. REYNOLDS PRESIDENT, CEO PENTEGRA GROUP

What types of benefit programs will bankers want to offer their employees in the future? Here's what Pentegra believes banks will offer.

Stock-based retirement programs will continue to grow in popularity as

more mutuals convert to stock organizations. Traditional defined benefit plans will see a resurgence in popularity as baby boomers become the first generation to find out that 401(k) plans alone do not provide adequate retirement income. Defined benefit plans will continue to provide the most secure type of retirement benefit because they provide a known level of income, and the investment risk is borne by the employer.

Frequent job changing will necessitate increased retirement planning and investment education efforts. In the future, participants will look not only for investment education, but investment advice to help them bridge the gap between frequent job changes and the subsequent effect on retirement income. Expect investment advice, retirement counseling and financial planning to augment traditional investment education.

As Internet-savvy consumers continue to emerge as online investors, instantaneous account access, online transactions and confirmation of trades will become the norm. The Internet will replace traditional forms of benefit communications, becoming the preferred mechanism for communicating plan features, retirement and financial planning information, and personalized benefit tools.

ATMs

ANDREW HARRIES VICE PRESIDENT, MARKETING SIERRA WIRELESS

Wireless voice and data transmissions have proven their value in the fields of public safety, transportation and public utilities for more than a decade, delivering continuous, reliable communications in mission-critical applications where every second counts.

Financial institutions are recognizing the benefits as well. Leading hardware manufacturers are delivering wireless modems that redefine customer service by putting bank databases at the fingertips of mobile professionals. Now, a loan officer can submit an application from any remote location, speeding processing and delivering an answer as quickly as possible.

This technology also allows for wireless transaction processing systems that eliminate the constraints of searching for phone connections when placing ATMs. Even mobile installations aboard ferries and riverboat casinos are possible. If customer traffic is sluggish at one site, banks can easily choose a better location.

In 10 to 20 years, wireless data may actually boast faster speeds than most landline-based systems. At the very least, they'll exceed the performance of existing dial-up services, enabling interactive, multimedia experiences at portable kiosks which can offer more services than existing ATMs. Customers will be able to interact with a real teller from any banking terminal, rather than hunting down a branch for personalized service. Today and tomorrow, whether customers are online or in line, wireless technology offers banks an affordable way to deliver better service.

DAVID GRANO PRESIDENT, CEO CARD CAPTURE SERVICES

In "The Road Ahead," Bill Gates outlines a future in which electronic kiosks offer pay phone, banking and Internet access and e-mail and e-commerce capabilities. "Access to kiosks will be essential and available everywhere," writes Gates. This future is closer than you may think. Today, ATMs in the U.S. are ubiquitous, Internet-ready and poised to become the electronic kiosk of the future. For community banks, expanded ATM capabilities means a low-cost way to deliver new ecommerce products and increased customer service. However, with limited regional scope and budgets, how will community banks succeed in the brave new world of ATMs?

Due to their wide consumer acceptance, ability to distribute printed materials and on-screen messages, and high crossover with Internet users, ATMs represent a burgeoning opportunity to extend the potential of the Internet. Emerging ATM hardware or software will directly connect online banking and ATMs. Significantly, a leading online service, amazon.com, recently began advertising on Wells Fargo ATM screens. These are the first steps toward cementing the Internet ATM link. In the near future, ATMs will become alternate delivery networks for e-commerce, offering smart card and

stored value access and loading, consumer bill payment, monetary transfers, and event and airline ticketing and distribution on a national basis.

What will these changes mean for community bankers? The good news for banks considering new machines is that hardware costs are coming down as functionality rises. Therefore, ATMs are becoming a better value. Furthermore, adding new functions to an existing ATM network may not require new hardware. In terms of ATM program planning and development for the future, community banks are discovering outsourcing as an option. In recent years, companies have emerged to offer ATM outsourcing programs for community banks. Because their sole focus is ATMs, these companies can offer customized, lower-cost ATM programs, the most current ATM technology, and attractive retail locations.

In the final analysis, customers reward companies that can successfully identify, and then meet the needs and expectations of consumers over the long term. Community banks have made their mark with customer service. As new ATM services evolve, they will continue to be a meaningful component of customer service strategy in the years to come.

KEN PAULL VICE PRESIDENT, SALES AND MARKETING TRITON SYSTEMS INC.

Is the automated teller machine (ATM) destined for greatness or the history books? Make no mistake, ATMs will play an even larger role in a community bank's ability to get closer to customers, while improving profitability.

With the linkage of ATM networks, computers and the Internet, ATMs will rank among the most convenient of shopping and banking channels. Banks will **profit**lt; as customers use ATMs to view customized ads, order flowers, buy and sell stocks, reload smart cards, or accomplish traditional banking activities such as applying for loans and paying bills-all the while feeding invaluable data back to the bank. The future may even see "ATMonly banks" that serve computer-wary users while saving the operating expense of brick-and-mortar branches. Multiple ATMs side-by-side may become a familiar sight, with cash-dispensers situated next to more specialized ATMs.

With growing use of wireless transmission technologies like CDPD and satellite, customers will be able to conduct transactions from airplanes, cars, or virtually anywhere, and deployers will be able to move their ATMs wherever, whenever they are needed most-to ski resorts in winter or beach communities in summer.

As ATMs become even more ubiquitous, geographic banking boundaries are likely to blur, giving banks an unprecedented opportunity to serve a different kind of community-people with similar needs and tastes who are dispersed geographically. Who knows? ATMs may bring entirely new meaning to the term community bank.

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Borrowers, What the euro means to America

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What does the birth of a big new capital market in euros mean for the world's existing pool of liquidity, the US market? So far, few US borrowers have issued in euros, but they, along with American investors, are keeping a keen eye on the development of the market.

Last month, Euromoney hosted a one day conference in New York on the subject of the euro, allowing some rather defensive Europeans and sceptical Americans to exchange their pungent views on the first months of Europe's new currency. J|rgen Stark, deputy governor of the Deutsche Bundesbank, kicked off by conceding that, since the start of the year, initial high expectations for the currency had given way to a measure of disillusionment, while arguing that the dollar's strength may partly be the product of its status as a safe haven during the Kosovo crisis. He also pleaded that, "four months is too short a time for a conclusive evaluation".

Wolfgang Ruttenstorfer, Austrian secretary of state for finance, sought some perspective on recent euro weakness by pointing out that the theoretical value of the currency had spiked late last year in the run-up to its launch, and it has now returned to a level only slightly below its 1998 average against the dollar. This, along with attempts to portray euro weakness as in reality dollar strength, is part of an increasingly familiar official European line. And Ruttenstorfer recalled the enormous scepticism from outside Europe in recent years that it would ever achieve the required convergence to create the single currency at all. "The sceptics have been proved wrong," he thundered. But also added: "Europe needs to strengthen the forces of internal growth to tackle our appalling unemployment levels and we must reduce our growth differential with the US before the devaluation of the euro versus the dollar reaches the point of destabilizing financial markets."

Caroline Atkinson, senior deputy assistant secretary for international affairs at the US treasury, picked up on this, transmitting some of the impatience of her boss, Larry Summers, that the world economy is now like an airliner trying to fly on the single engine of US growth. "Understandably, European policy-makers have focused on how to introduce the currency," she said. "But the Emu block is more than the sum of its parts and its policy decisions have affects on the rest of the world. It is not appropriate for a closed euro area to rely on export-led growth."
While some argued that the euro has fared surprisingly well during its first 100 days which saw unexpectedly weak growth in the main euro economies; a political crisis leading to the resignation of the entire European commission; barely concealed arguments between finance ministers and central bankers; and a war breaking out on its southern border, there were other voices of concern during the day about the effectiveness of new European institutions.

No, no and no

Cisar Molinas, co-head of European fixed income strategy and economics at Merrill Lynch, scathingly described the ECB's performance in terms of the three nos: "No data, no strategy, no transparency." He expressed doubts about that the harmonized M3 data series the ECB is using, pointing out that it is very short and does not even make allowances for seasonal influences on money supply. As to its strategy, he questioned how the ECB could have a target limit for M3 growth of 4.7% and still cut rates with M3 growing at 5%. "I suppose the ECB would say it's being flexible." And as to its transparency, Molinas observes: "A box with nothing in it is see-through, but I'm not sure that's the same as transparency." He concluded that the ECB's real troubles will start when it has to hike rates aggressively to contain inflation to its stated 2% limit.

So it was with some relief that conference delegates tuned into a slightly calmer debate on the impact of the euro on the capital markets and listened to the experiences of American investors and borrowers: many watching the euro from the sidelines, some having pitched straight in. Chris Whitman, head of US syndicate at Deutsche Bank summed up the pricing considerations which explain why so few American companies have launched euro deals this year, while their European peers have been pumping out bonds: "For a lot of the single-A rated US issuers we cover, the US investor base has a sharper pencil than the European investor base. And the basis swap from euro into dollars has also kept people out, although some issuers may be attracted, like Philip Morris, which get less good pricing in the US than their rating would suggest." Whitman says that the raw cost of swapping from Eurasia to dollars is some five basis points for a credit used to borrowing at Libor flat. The higher a borrower's spread over Libor, the greater the extra cost of borrowing in euro and swapping back to dollars. A single-A rated borrower at Libor plus 25 will pay between five and nine basis points more to swap from euros into dollars and a high-yield issuer at 200bp over Libor might add 20bp to its costs.

Neil Schloss, assistant treasurer at Ford Motor Credit recalls its EUR 1 billion five-year deal earlier this year: "This marked something of a shift in our borrowing strategy, though we have done significant transactions in the past in European currencies. We decided that, because of its sheer size, we cannot ignore the euro market. Last year, we did a Deutschmark deal with the intention of redenominating it into euros and during the first quarter of this year we waited for the economics of the swap market to be right and were eventually able to issue at flat to our US levels." He concludes: "We see this as a major opportunity."

Paul Robillard, treasurer at Hydro-Quebec says: "Our issuing style is to be opportunistic and we have been active in core Europe since the mid-1970s and want to maintain our name in that market." But Hydro-Quebec has not issued in euros. "During the first quarter we had expected the euro market to compete a bit more with the dollar market, whereas in fact the euro market has been 10bp to 12bp more expensive on a Libor basis than the dollar market for 10 years." But he sees some potential advantages of issuing in euros in future, particularly in expanding the investor base: "We've not been active with Italian and Spanish buyers in the past. But these now seem to be very receptive to credit stories."

Looking further ahead to future developments in the European capital market Alan Anders, head of borrowing at the city of New York, expressed some interest in the growing municipal bond sector in Europe. US municipalities borrow predominantly in the domestic market, where tax exemptions on interest income for American investors in US municipal bonds permit a borrowing cost sometimes below that of the federal government. But US municipals lose this tax exemption on borrowings where **proceeds** are earmarked for certain uses such as affordable housing programs and funding pension liabilities.

New York borrows a modest $200 million out of $4 billion a year at taxable corporate rates. In the past, it has borrowed in Japan and has taken $1 billion from the Eurodollar market. "What we are looking forward to is that there may be a window for US municipals to access that growing European muni market."

What US investors want

Charles Van Vleet, co-chief investment officer for fixed income at Warburg Pincus made a plea to European issuers to provide simple structures, full disclosure and securities that are swappable, if they want US investors to buy their euro bonds. Van Vleet provided an interesting perspective on European self-congratulations at the creation this year of a more diverse corporate bond market including more double-A and single-A rated issuers. "I don't want single-A or double-A-rated bonds. I don't know where to put them. My objective is a core area of liquidity with triple-A bonds and then triple-B bonds to be my alpha generator of performance. My demand for liquidity is increasing because investments under management are getting bigger, while there is decreasing liquidity in some G7 bond markets and contracting dealer inventory. I don't need credit analysts on triple-A-rated bonds and I'd rather expend my scarce credit resources on triple-B debt."

He added a plea for issuers of euro bonds to go through the extra expense and disclosure requirements of global or 144a formats so US buyers can purchase them immediately: "I can't tell you how important it is for me to follow bonds from the very start." The identity of a bond deal's underwriters is also important to Van Vleet: "I like firms with multi-sector sales coverage who can reach cross-over buyers - investment-grade buyers crossing into high yield, high-yield buyers crossing into emerging markets - and with a strong crossover to equity because I rely on my equity people for high-yield debt analysis. And I like firms that sponsor indices." So quite a demanding guy, all told.

Vache Mahsererdjian, strategist in the US fixed-income group at Barclays Global Investors, makes the obvious point that European investors themselves will have much more impact on the development of the euro corporate bond market than American investors which are typically restricted to owning no more than 10% or 20% of their portfolios in non-US securities.

Perry Beaumont, global head of fixed income research at Axa Investment Management, warned that credit bond markets may evolve differently in Europe than in America: "I cringe when I hear analysts using Moody's and S&P's US default history as a baseline for Europe, given the very different bankruptcy laws and roles of governments between Europe and America."

And David Boal, senior portfolio manager at Bank of Ireland Asset Management, added that national considerations still have an influence on pricing of European industrial company bonds which may be baffling to American investors' credit analysts. "America is a nation. Europe is not a nation - yet. When unrated Fresenius from Germany did a five-year EUR 400 million bond, because of its great local name recognition, 80% of that deal went to German buyers and it was priced at 139bp over. Various analysts have said that if that deal had been marketed internationally it would have been priced at 180bp over. This kind of thing is an impediment to European investors in Europe."

Jaswinder Sandher, head of US syndicate for high-grade bonds at Barclays Capital, thinks that a strange imbalance in the euro capital market - whereby European investors have suddenly become desperate to buy credit bonds - may yet work itself out in interesting and unexpected ways. "US borrowers who are not so well known in Europe are now being priced wider by European buyers than equivalent rated European borrowers and most US issuers are paying a premium to issue in euros. However demand in Europe is far in excess of European supply. Some accounts in Europe are already buying US domestic bonds. And in future, US borrowers may find an opportunity to borrow cheaper in euros and swap into dollars."

Further in the future, once price differences based on national factors erode, Sandher suggests that it will be increasingly easy for US investors to compare dollar bond issues directly with euro issues swapped into dollars. "That will offer every corporate in the world, for the first time, a choice between two very liquid markets." Though he adds: "It may be that we will see whole classes of borrowers all going entirely into one market or the other, for example utility issuers suddenly all borrowing euros, because of a price advantage leaving US investors with no new dollar bonds of utility issuers to buy."

But for the moment John Isaacson chief investment officer at US fund manager Payden & Rygel remains sceptical of the approach of many European investors: "They are yield hogs who don't actually look at their assets as a portfolio or look at the total return of their portfolio, so much as they follow what happens to each specific bond they own. I have to wonder what are the implications of the lack of a credit culture in Europe. BMW can borrow at 40bp over in Germany while Ford pays 70bp over here. Why? And when will some of these anomalies disappear?" Good questions.

To explore further the developing expectations and experiences of American investors and issuers with the euro, Euromoney conducted a handful of longer interviews with American fund managers and profiled two recent expeditions by American corporate borrowers into the euro bond market.

FIDELITY INVESTMENT

John Ross, director
What attracts American investors to the eurozone?

Look, it's the second largest stock market in the world and with all the changes is set for a highly dynamic period. Over time, this is a large trading block that will become more homogenous.

There is even talk of stock exchanges merging and ultimately even a central dealing area.

Add to that the fact that US institutions' pension funds are seeking to give a higher weighting to non-US investments, and Europe has got to be given a fair degree of concentration over the next period. So far, of course, the flow of money from the US into the eurozone has been curtailed by the view that growth and **profits** in euroland are slowing down. An improving outlook towards the end of this year would act as a catalyst for US investor institutions to increase their weighting.

How will Emu affect corporate behaviour?

Corporate tax rates are the key thing here. There is a huge divergence from the 52% rate in Germany to rates of about 20% in Ireland. People are asking why a company would want to pay corporation tax of 50% when they can move to Ireland. By 2003 Ireland is going to have a basic rate of tax of 15%.

Shareholders will put pressure on companies to move to lower tax areas so governments will have to lower corporate tax rates to keep companies based locally. If the companies don't move they will shift their tax liabilities around to pay more tax in a lower tax area. An example, even though not inside the eurozone, is Ericsson, which considered moving to London just because corporation tax rates are lower there.

Which types of European corporates are being targeted by investors?

European pension funds are rebalancing their institutional portfolios as rules are relaxed on external investing. The knock-on effect has been a reduction in holdings within small and medium-size companies within their domestic market and a growing interest in large companies in the eurozone. And that rebalancing is creating a large liquid market in the largest 100 companies within the eurozone. Normally, a US investor would also look at the largest companies, at least to begin with. So large companies are currently flavour of the month.

Where do banks see their opportunities in Europe?
The corporate bond market. The high-yield market in Europe will be an increasingly competitive market for banks. Companies will move from getting their borrowing from banks to borrowing in the debt market. A lot of companies are seen to be under-geared in Europe and cash rich. Perhaps they could restructure their balance sheets to borrow more efficiently.

What has the new Europe meant for Fidelity?

We have converted some of our funds to euro-denominated funds. We launched a euro blue-chip fund, and we have converted a German tracker fund into a euro stocks index tracker. Some of our asset-allocation products, our managed products, are being offered as more of a discretionary managed portfolio service. In the past if we were selling this type of fund in Germany, we might have 40% invested in Germany. Similarly if we were selling the same product in France we would have 40% in France. Now this 40% in the base currency is offered in the euro.

The discretionary funds no longer have to be country-specific.

There are three classes of funds: the defensive fund which is primarily bonds and cash; a moderate growth fund, which is about 60% equities and 40% bonds; finally there is an aggressive growth fund of 100% equities. We can now have one euro bond fund and a euro cash fund rather than separate funds for Deutschmark and franc bonds and cash. The moderate growth fund, instead of holding 20% in Deutschmark-denominated funds, can now include euro blue-chip investments. The aggressive fund now has 40% in the euro blue-chip fund.

Will any of this change if the UK joins Emu?

If the UK were to join the eurozone, the European stock market would be even bigger and this would be another reason for increasing portfolio foreign-exposure weightings in Europe. Certainly our eurozone funds would then take the UK into account. However, it is not yet decided whether we will include the UK in the eurozone.

Within most of our existing eurozone products we separate the UK from continental Europe. Apart from our European smaller-companies fund, which includes the UK and continental Europe, our funds are either continental Europe or UK. That is because UK investors have wanted to make asset-allocation decisions themselves. On the continent investors have had a strong bias away from the UK, based on the UK's historically weak currency. If the UK joins the eurozone, the currency will no longer be a question. The UK would be the largest and broadest stock market within the eurozone and I can see European investors taking a better view of the UK. For UK investors, it is debatable whether there would be a lot of change. My feeling is that UK investors would still want to differentiate between UK exposure and eurozone exposure.

Have political events in Europe affected market performance?

The political thing just does not come into our thinking. We are really concentrating on individual companies. Politics is not an important investor variable. Lafontaine was not good for German business given his tax plans, and then not good for the eurozone because he created a lot of misunderstanding. However, his influence and resignation were a German matter. For us it was just noise. Whether he is there or not does not affect how a company does its business or how it is run. - Nick Kochan

PIMCO

Lee Thomas, senior international portfolio manager

Has the euro changed the way US investors manage their money?

Other than for a small number the answer is no. But for bond investors such as Pimco it certainly has changed the way we invest. The old convergence trades have gone and now we are starting to see a change towards credit analysis as a required skill rather than the skills of macroeconomic analysis which were important before. The first stage is CLOs (collateralized loan obligations), as banks start to shed assets. And we are beginning to see the development of a corporate bond market.

For equity investors, it is a case of having to consider which companies will be the winners and losers. In each country you now

have a virtual oligopoly producing each type of key goods. Instead you are going to see a handful of pan-European companies emerge. You have to work out which will be the acquirers and which the acquired. In car-making, for example, you have a large number of producers. Ultimately, there will only be a handful.

Is Pimco's European strategy focused on winning new client money from Europe or in channeling US funds into European investments?

We have just opened a European office, and our intention is to do both. But I am especially interested in attracting European investors as the market in this continent becomes more like the market in the US. We believe we are able to offer a useful service to European investors.

How are Pimco's skills different from those of European asset managers?

Bond investment in Europe tends to be top-continued on page 177 down and driven by macroeconomic analysis. It has been very important for analysts to have good contacts with government. In the future there is going to be only one yield curve - I am making the assumption that countries such as Sweden and the UK will join the euro in due course - and that will mean less opportunity for exploiting changes in interest-rate spreads. There will be just one to play with. The new environment will require a different skill set. It will require strong skills of credit analysis and better quantitative skills. Analysts in the US, where the focus is often on CLOs and mortgage bonds, have a different set of skills.

The European players could try to take their economists and train them up as credit analysts or they could hire in new people. And I think it is far more likely that they will hire. You will see them recruiting people from the ratings agencies and you will also see a flow of credit analysts from banks to asset managers.

Borrowing in Europe is much more intermediated than it is in the US. In America banks intermediate one-third of all corporate borrowing. In the Europe the figure is two-thirds. As banks start to do less lending they will find they have too many credit analysts. Or, alternatively, you will see movement within banks, from the lending operations to the asset management side.

How do US investors view Europe?

Most investors in all countries tend to have a preference for domestic investments. No matter how cosmopolitan we feel we have become there is always a bias in favour of domestic securities. But some fund managers have dedicated allocations to foreign **investment**. Our investors allow us some **discretion** to invest abroad. Pimco's foreign portfolio, for example, has grown substantially. Four years ago our foreign and global allocations were worth $800 million. Now we have $6 billion under management. The industry as a whole has not grown like that, our market **share** has been expanding.

Which type of investors are more enthusiastic about Europe,

pension or mutual funds?

Most of the money moving into Europe is pension money. Those funds tend to be carefully managed with a view to the long term and there is scope for global asset allocation. So they tend to be the most enthusiastic. Mutual funds are less interested.

What is the split of Pimco's portfolio in Europe?

Pimco is trading a lot on European outs versus the ins. So, for example we are overweight in the UK on the basis that it will cut rates. We are also overweight Sweden. And we have bought a lot of Danish mortgages. That is balanced by being underweight core Europe, especially Belgium. One major position is the bet that the slope between 30-year and 10-year yields will flatten.

One absolute scream is for UK 30-year gilts against 30-year euros. There are a small number of institutions that buy gilts for their long duration and ultimately then they will be able to buy 30-year bonds from Germany, Spain and so on. So spreads will come down.

So convergence trades are still more important than credit?

Yes. At the moment there are still very interesting convergence trades. We are overweight Greece, for example, and we put on that trade when Greece was considered an emerging market not a candidate for Emu. Now, on the same basis we are investing in Poland and the Czech Republic. I have long been an advocate of buying Poland, although lately it has gotten quite expensive.

Do many US investors take the view that Europe is  a lost cause economically?

Most American investors don't really think about these issues. Of those who do there is one group who do see the continent as a lost cause, as somewhere with such fundamental structural rigidities that has little hope of economic growth. But that view is not universal. There is another group of US investors who think that we will see the same sort of supply-side revolution in continental Europe as we did in the UK and the US in the Reagan and Thatcher years, and that the euro will encourage that process. I am closer to that camp. I don't think Europe is going to crumble away. I personally think it will become more interesting. - Michael Peterson

STATE STREET

Alan Brown, group chief investment officer, State Street Global Advisors

How do you expect the euro to affect the capital markets?

We expect one of the good side-effects of the euro to be a significant expansion of the role of the capital markets in financing European business, both at the equity level and at the bond level. At the equity level, management should become more concerned about creating shareholder value because they will be looking to shareholders to supply their capital more than they have in the past.

Private sector, or privately listed, companies who in the past

have half-ignored their shareholders because their financing needs were met from the banks, are going to have to pay attention to what shareholders think, and that is good.

And the implications for bond issuers?

We have moved from the position where we had a very fragmented series of national bond markets, dominated almost exclusively by government bonds, to an integrated euro bond market, where the various sub-governments will effectively trade on spreads to Bunds. It will be a much larger market, with a much greater critical mass. We would expect to see, courtesy of Goldman Sachs and others, a rapid expansion in the type of fixed interest instruments available over here - the introduction of things like asset-backed securities, mortgage-backed securities, low-grade debt, all as alternative means for companies to finance. So the Eurobond markets should begin to rival the US bond market in terms of diversity. They are already beginning to rival it in terms of size.

I think it will start with corporate bond issues, maybe mortgage backed, but this is going to be fairly rapid. I don't think in four years' time we will be saying it has not really happened yet. I think you will see this beginning within the next 12 to 24 months in a fairly serious way.

Are there any other consequences for the bond markets?

There is an interesting and little observed quirk to remember about these euro government-bond markets. We now have 10 countries - if we ignore Luxembourg - which are the only significant countries in the world issuing government debt without the backing of a lender of last resort, that is a central bank. When the US treasury issues treasuries, ultimately the US controls the Federal Reserve and can print the dollars - even if they are dollars that are devalued through inflation - to repay the debt. Similarly, when the UK issues gilt-edged securities, the Bank of England can print pounds to repay the debt. This does not apply to the 10 countries in Europe because the European Central Bank (ECB) is specifically not mandated to bail out any one of them. And therefore there is a case for arguing that they should command a risk premium compared to other government debt. And that risk premium, if any country happened to get into trouble, could of course then grow to be quite big.

There is another side-effect for the bond markets. Now that the process of convergence is over, the number of bond markets in the accepted benchmarks like JP Morgan's or Salomon Brothers' global bond index has dropped by over a half from about 17 to around seven or eight. So if, as a bond manager, you used to try to find additional return by making country decisions, you now have less countries to choose from - about half. And if your skill of picking amongst countries is the same as it was before, then the excess return you earn - the value-added divided by the risk - will fall to a quarter of what it was before. This means that trying to make money by country decisions will be a lot harder. That is very significant because most British bond managers have sought to make money for their clients principally out of market decisions, currency decisions and maybe maturity decisions. Now one component of that has been, if not removed, then made much more difficult for them.

What impact has the euro had on the investment banking community?

They are going to have to learn techniques related to mortgage-backed securities, low-grade credits, asset backs - and that is an area where most of the world's expertise resides in the States.

So one thing you should expect to see, and I am sure every major US firm has taken the cue, is that we are gearing up for an onslaught in Europe, for what we believe is a terrific opportunity in the debt markets. Because the only people who really know about all these credit issues and embedded option issues are US firms who have been doing this within the US for some time.

We are also blessed with the advantage that nobody else has a track record in euros - it has only been in existence for one month. So we are not at a competitive disadvantage in terms of other firms being able to say we have done this before, because nobody has done it before. So one side effect of this is that you will see the investment banks coming in with all sorts of debt options for companies on the issuing side. And on the buy side you will see firms like State Street making an aggressive push into managing debt portfolios for all the European institutions.

What about the perspective of the US investor in euroland?

The truth is that European markets themselves are correlating more and more as they come together in euroland. So you are finding Americans asking: "Am I finding all the diversification benefits I really hoped for?" Tactically, I think people look at euroland as being a reasonable place to be for the short term, on the grounds that they would expect the ECB to be relatively tough on monetary policy initially as it establishes its credentials. At the same time on the fiscal side, with a more left-wing bias to euroland, it looks as though, within modest limits, they will relax fiscal policy. So growth in euroland, in what is going to be a poor year for the world as a whole, looks relatively bright.

How do you see the outlook of the euro against the dollar?

A somewhat weaker dollar. Equity market valuations in Europe are not as high as they are in the US or in the UK. So if one is concerned about the level of Wall Street, Europe looks a slightly better bet. Tactically, Americans view Europe as being a reasonable place for this year. A combination of reasonable growth, slightly looser fiscal policy and comparatively tight money policy is usually a good environment for a currency. So I think they look at the euro as being a reasonably safe place for 1999, possibly appreciating against the dollar.

And the equity markets?

A lot of the equity markets are now being consolidated within Europe. Although there are going to be continuing return differences between the Belgian exchange and the Spanish exchange, capital markets are likely to begin to behave more and more like one capital market. Effectively they are going to look more and more like one capital market with several exchanges,

which is no different to the US where you have New York and the Nasdaq.

You will continue to see differences between returns in Belgium and returns in Spain, but basically it is one capital market so the importance of sector rather than country decisions is likely to grow. It won't be an overnight event and there will still be perceived differences in returns between one country and another just because there are different companies listed there. But the driving force is a shift away from countries towards sectors. That means that fund managers who have been used to making country decisions, and then picking stocks within countries, are going to have to re-adjust.

Have investor attitudes changed towards the country distribution of their portfolios?

In the past Dutch investors thought of their home market as something denominated in guilders. Now, with the arrival of the euro, they will consider it to be something denominated in euros, which includes 10 other countries. So you should expect to see some portfolio rebalancing amongst European institutions. The Dutch will be natural sellers of Dutch equities and buyers of everything else in Europe and vice versa as you go round the region. And that would be extremely interesting if the UK were to join.

The UK has a particularly large savings pool in pension assets, mostly invested in equities. Europeans, on the other hand, have relatively modest savings pools, and their pensions are still mostly invested in bonds. Now if we were all to rebalance our portfolios, British funds would be very large net sellers of UK equities and buyers of continental European equities with no substantial offsetting inflow into the UK. - Nick Kochan

SCUDDER

William Holver, lead portfolio manager, Scudder growth fund and Scudder income funds

How has the launch of the euro affected sales of your funds?

I am disappointed that it hasn't done better and I am a bit surprised at that. One would have thought that the natural diversification opportunities available to American third parties, who have got something like 90% of their money in the dollar, would have been taken up. In the longer term, it's an opportunity, of course. But I would have thought it would be in the shorter term too.

I come from the vantage point of owning a lot more German stocks than any others in continental Europe. I see the euro as being one of the elements that provides favourable conditions for convergence. The end of national monetary, and eventually fiscal, policies - some uniformity - will come into play and that will be great for getting down capital-**gains** taxes in Germany and ensure that all their cross-holdings - which had frozen because of that unrealized liability - are far more likely be freed. Investors in those conglomerates will benefit considerably as a result.

What will most attract international investors to euroland?

The most important change is in the regulatory environment. Insurance companies and other institutions, which have been bound by industry regulations limiting their purchases of foreign-currency-denominated investments, are now finding their investment criteria changing dramatically.

The result is that, in effect, everybody becomes domestic, and this has had a meaningful impact on investment behaviour, especially in small countries like Belgium that have not been able to get exposure across the various industrial sectors.

This change in investment patterns is in part responsible for the rise in the markets earlier in the year. And it has probably supported trends towards investments in larger companies as well. This will probably remain an influential factor, although not all the countries have implemented changes to the same extent, or in quite the same ways.

Do Americans want more exposure to European markets?

I know Scudder did, but we started with a great deal of exposure anyway. At this firm, it is expected that European companies will restructure themselves in the same way that European corporations have been restructured. Whether that is right or wrong is another question. But that would provide huge inputs into earnings.

Who is more interested in the euro's prospects, the bond or equity investor?

A bond investor is much more excited as it raises the importance of credit differentiations with Europe's bond market. If you buy US bonds and go to Europe, you used to have the choice of French ones, English ones and German ones. And you'd ask, what are the rewards of one compared to another? The issue that distinguished them, of course, was the currency risk. So you bought them and worried about that risk. Now, there is no currency risk between the various markets. But are they all going to sell at the same yield? No, they are not. Because some issuers, like the government of Italy for example, have a huge stock of accumulated debt, whereas perhaps Nestli or Unilever haven't. So which would you prefer, Italian government bonds or Unilever's? You then have to do a whole credit-rating thing. That excites bond dealers.

What are the euro's implications for monetary policy?

There is no question the members of the eurozone countries have given up sovereignty over their own money. They can't print money to make good budget or account deficits. The implications and numbers of unanswered questions are considerable. If a city or a country had a problem, they can't, as they did before, print money. So does that mean they would have to raise more taxes locally? Or would they have to go to the central bank, like they used to, to get bailed out?

Then the question is which central bank?

It is not clear whether they would go to their pre-existing central bank - which can't print money, but still has resources - or to the one in Frankfurt, the Central European Bank. These are some of the questions that must be tackled.

Is the new Europe a more coherent political and economic entity?

Will it attract more international investment?

What matters much more than a great political scheme is that the European leadership creates a business environment that supports wealth creation. The most important factors are that the Germans somehow resolve the issue of tax obligations on latent or hidden assets; that the marginal benefits of tax encourage people to go to work and to change jobs, and that they encourage venture capital. Those are far more important issues than the geography of the place.

The geographical issue that is outstanding is the enlargement of the European bloc. The next big question may be whether Poland, the Czech Republic and Hungary gain membership. That would be positive for the wealth of Europe and equity opportunities. They have got the potential to grow much faster than the mature core and would provide new and, in the long-term, dynamic markets for the rest of the union, which could clearly use a fillip. - Nick Kochan

FORD MOTOR CREDIT

"Every major US borrower is looking at issuing in euros," says a London head of syndicate. "But the problem for all of them is cost."

For the first three months of this year issuance in euros has boomed. But no more than a handful of US borrowers have accessed the sector. Several of those US issuers who have brought euro deals have been banks with a large euro funding requirement, such as Lehman Brothers and JP Morgan, or multinational manufacturers that do substantial business in Europe, such as Xerox and Gillette.

But the biggest US borrowers - those that typically need to swap foreign borrowings back into floating-rate dollars - have been notable by their absence. The reason is that the volume of euro issuance has driven up the rate at which borrowers swap fixed-rate euro liabilities into floating-rate dollars.

Ford Motor Credit's EUR 1 billion five-and-one-third year offering in March, lead-managed by Credit Suisse First Boston, Lehman Brothers and Merrill Lynch was - alongside EUR 1 billion seven-year deals from GMAC in January and Philip Morris in March - the largest euro deal from a US borrower in the first five months of 1999. And the issuer's attitude towards the euro sector is typical of many large US borrowers.

"We view the euro as a very important currency," says Ford Motor Credit's treasurer, Dave Cosper, "and one that should give us access to many new investors. But for the first couple of months of the year it was more costly to issue in euros than in dollars."

Ford Motor Credit was one of several borrowers that began to cultivate the market last year. Last June it issued a Dm2 billion ($1.1 billion) bond. That offering, with a maturity of 10 years, on which Goldman Sachs acted as bookrunner, was very well received. "We see that as our first euro issue," says Neil Schloss, Ford Motor Credit's assistant treasurer. "That deal can be redenominated into euros and we plan to do that so that all our euro issues are easily transferable."

The borrower's March deal was done through a narrow window in "The deal was made possible because the euro weakened in February," says Cosper. "We pride ourselves on our ability to react quickly to opportunities. And we beat other issuers to that window which is now closed."

A banker for one of the bookrunners on that deal says: "Ford were



**Company Names (DIALOG Generated):** Axa ; Bank of England ; Bank of Ireland Asset ; Barclays Capital ; Barclays Global Investors ; Central Bank ; Central European Bank ; Credit Suisse First Boston ; Deutsche Bank ; Deutsche Bundesbank ; Ericsson ; ECB ; Ford Motor Credit ; Gillette ; Hydro Quebec ; Investment Management ; JP Morgan ; Lehman Brothers ; Merrill Lynch ; Payden & Rygel ; Philip Morris ; Salomon Brothers ; State Street ; Unilever ; Various ; Xerox

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Outlook brighter for financial modernization bill
Anonymous
ABA Trust Letter , v 401 , p 1,14+ , Apr 1999 **Document Type:** Newsletter Article **Article Type:** News
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**Abstract:**

The legislative saga of financial modernization continues, but the chances for passage are better now than they have been for awhile. On March 11, the 1999 version of HR 10 was reported out of the House Banking Committee by a vote of 51-8 and was referred to the House Commerce Committee. A week earlier, on March 4, the Senate Banking Committee reported out its version of financial modernization.

**Text:**

The legislative saga of financial modernization continues, but the chances for passage are better now than they have been for awhile. On March 11, the 1999 version of H.R. 10 was reported out of the House Banking Committee by a vote of 51-8 and was referred to the House Commerce Committee.

A week earlier, on March 4, the Senate Banking Committee reported out its version of financial modernization. Senate Majority Leader Trent Lott (RMS) has included financial modernization on his list of bills slated for early Senate action, and full Senate consideration is likely to begin the week of either May 3 or May 10.

Back in the House, the Commerce Committee may wait for the outcome of Senate floor consideration. It has until May 14 to complete its work on the

bill, at which time House floor action will also be scheduled.

ABA Urges Action

Following these favorable legislative developments, on March 19 ABA President R. Scott Jones wrote to all members of the U.S. Senate and encouraged them to bring the Senate bill to the floor for a vote as soon as possible. The letter underscored some of the provisions in the Senate version that the ABA particularly supports, including the proposed streamlined structure for the affiliation of financial services firms and the securities and insurance regulatory provisions. The latter represent an agreement reached for the first time between the insurance and banking industries on an appropriate structure for bank insurance activities.

The Senate bill also includes several provisions that would help community banks improve their liquidity and exempt rural banks from the Community Reinvestment Act.

The ABA also strongly supports the Senate bill provisions that prohibit the chartering of thrifts by commercial companies in the future. An amendment will be offered that will extend the prohibition to also cover the acquisition of thrifts by commercial firms.

The Privacy Language

Once the financial modernization bills are passed by the House and Senate, a conference committee will be called to work out the differences between them. One such difference involves a new subtitle on privacy added to H.R. 10 during House Banking Committee consideration. No similar language is presently included in the Senate bill.

The privacy subtitle would require depository institutions of financial services holding companies to clearly and conspicuously disclose to customers their privacy policies. Under the new language, privacy disclosures must explain the institution's policies on disclosing customer information to third parties for marketing purposes and include the disclosures required under the Fair Credit Reporting Act concerning consumers' right to choose not to have their information **shared** among affiliates.

The privacy provisions also

* prohibit insurance companies affiliated with banks from sharing confidential customer health and medical information with the bank;
* incorporate H.R. 30, the Financial Information Privacy Act of 1999, which prohibits the acquisition of financial information from a financial institution by false means; and
* require a study of how well current laws protect the privacy rights of customers of insured depository institutions.

Trust Activities Provisions

Under both the House and Senate financial modernization bills, banks may effect securities transactions in their trustee or fiduciary capacity. The House bill includes language requiring that trustee compensation be on the basis of an administrative or annual fee (payable on a monthly, quarterly, or other basis), on a percentage of assets under management or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions, or involving any combination of such fees. There is no corresponding language in the Senate bill.

"Fiduciary capacity" is defined almost identically in the House and Senate bills as serving

* in the capacity of trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a Uniform Gifts to Minors Act, or
* as an investment adviser if the bank receives a fee for its **investment** advice; or
* in any capacity in which the bank possesses **investment discretion** on behalf of another or in any similar capacity.

The Senate version adds to the definition of "fiduciary capacity" the act of serving as a custodian for individual retirement accounts or a service provider to any pension, retirement, **profit** sharing,

bonus, thrift, savings, incentive, or similar benefit plan.

Transfer Agency Activities Provisions

Both bills also substantially agree with respect to stock purchase plans. Specifically, as part of their transfer agency activities, banks would be permitted to effect transactions in the securities of an issuer as part of any pension retirement, **profit** sharing, bonus, thrift, savings, incentive or other similar benefit plan for the employees of that issuer or its subsidiaries. However, the bank may not solicit transactions or provide investment advice in connection with these transactions, and the transactions must be conducted through a registered broker-dealer.

The House bill specifies that the bank's compensation for such transactions must consist primarily of administration fees or flat or capped per order processing fees, or both. The Senate version includes no such language.

Banks would also be permitted to effect securities transactions in connection with an issuer's dividend reinvestment plan or direct purchase plan, as long as the bank does not solicit transactions or provide investment advice, does not net buy and sell orders other than for odd-lot holders or plans registered with the SEC, and executes transactions through a registered broker-dealer. The House bill also specifies that the bank's compensation for effecting transactions for dividend reinvestment plans or direct purchase plans must consist primarily of administration fees, flat or capped per order processing fees, or both.

Safekeeping and Custody Activities Provisions

Again, both the House and Senate versions of financial modernization include substantially the same language with respect to permissible safekeeping and custody activities. Specifically, as part of its customary banking activities, a bank may provide safekeeping or custody services, facilitate the transfer of funds or securities, and act as a custodian or clearing agency in connection with the clearance and settlement of its customers' securities transactions.

Under the bill, banks may also effect securities lending or borrowing transactions or invest cash collateral pledged as part of their safekeeping and custody or clearance and settlement services. Finally, they may hold securities pledged by a customer to another person or securities subject to a repurchase agreement, and they may facilitate the pledging or transfer of securities by book entry.

One notable difference between the bills is that the House bill contains provisions governing banks and mutual funds. For example, H.R. 10 provides that a bank must register as an investment adviser with the SEC if it serves as adviser to a mutual fund. Registration may be accomplished through a SIDD, however. A SIDD, or a separately identifiable department or division, allows a bank to register with the SEC a unit of the bank and subject only that unit to SEC jurisdiction and oversight. The Senate bill contains no similar provisions

Chances for Passage

In the ABA letter to all Senators, Jones noted that on several occasions Congress has tried but failed to pass financial modernization legislation. Because consideration is so far along so early in this session of Congress, Jones said there is a "real opportunity" for enact- ment. He urged positive Senate action without delay.



**Company Names:**
American Bankers Association

**Classification:** 9190 (CN=United States); 8130 (CN=Investment services); 4310 (CN=Regulation); 9550 (CN=Public sector); 9540 (CN=Nonprofit institutions)
**Descriptors:** Bills; Regulation of financial institutions; Modernization; Congressional committees; Trust departments; Privacy; Bankers associations
**Geographic Names:** US

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72/9/16 (Item 16 from file: 267)
04543388
Venture Capital "Trust Me" The first page of every novel should be: Trust me, this will take time but there is order here, very faint, very human'". - Michael Ondaatje, "The Skin of a Lion"

Philip Sanderson & Jonathan Richards, Travers Smith Braithwaite
UK Venture Capital Journal
December 1,1998 **Document Type:** NEWSLETTER
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**Text:**

Every reader knows that even the best books may require a little patience during their first chapter. Similarly, some people may at first be put off by the technical issues involved with venture capital trusts (VCTs). However, in the two-and-a-half years since the creation of VCTs, many of these issues have been resolved. This article will give an overview of the VCT legislation, describe the restrictions imposed on VCTs in relation to the making of investments and explain how the conflict between those restrictions and the investor protections that venture capitalists normally expect has been resolved in practice.

In his recent pre-budget statement, Chancellor Gordon Brown said that "a strong venture capital industry supporting high-tech, high risk investments is critical to the future of Britain". Accordingly, the Chancellor promised various measures, including tax cuts, to promote investment, innovation and growth in small- and medium-sized private firms. Published at the same time as the Chancellor's statement were the findings of the Williams Committee, which had spent a year examining the ways in which high-tech firms are financed. The Committee proposed extending relief from capital

**gains** tax to investors in such high-tech firms to encourage the necessary investment. Although the Chancellor's statement and the Williams report particularly focused on high-tech companies, the proposed measures may come to complement other schemes that have already been introduced to plug the "equity gap" in the emerging company sector.

In his Budget of November 1993 the previous Chancellor announced a number of such measures, including the creation of a new type of listed investment vehicle called venture capital trusts. These were brought into existence through legislation incorporated into the Income and Corporation Taxes Act 1988 (the "Act") by the Finance Act of 1995.

One of the key parts of the legislation was the imposition of qualifying requirements on VCT's investments to ensure that available finance was properly targeted and that a proportion of each investment was genuine risk capital.

There have since been amendments to the legislation to sharpen the focus of VCT investment towards greater equity involvement in genuine risk enterprises. For example, the Finance Act 1998 introduced the "10% test" discussed below.

VCT Basics

VCTs were designed to confer certain fiscal benefits to encourage and enable private investors to channel their savings into small unlisted trading companies.

Briefly, the reliefs for private investors are as follows:

* Income tax relief - Private investors subscribing for new ordinary **shares** in a VCT receive income tax relief at 20% of the amount subscribed (up to a maximum of GBP100,000 in any one tax year) against their income tax liability in the year of subscription, provided that such **shares** are held for at least five years.
* Deferral of capital **gains** tax - Private investors can defer the payment of capital **gains** tax on any realised chargeable gain made on or after 5th April 1995 by reinvesting that gain (up to a maximum of GBP100,000 in any one tax year) in new ordinary **shares** in a VCT.
* Tax free dividends - Private investors are exempt from income tax on dividends received from a VCT (provided the **shares** were acquired within the permitted GBP100,000 maximum in any one tax year).
* Capital **gains** tax exemption - There is no capital **gains** tax on disposal of **shares** in a VCT (provided the **shares** were acquired within the permitted maximum of GBP100,000 in any one tax year) and conversely there is no relief for losses.

So far VCTs have received a favourable response. In the period from August 1995 to 30 September 1998 more than GBP535 million has been raised by 26 separate VCTs. By the end of September 1998 GBP187 million of that total had been invested through 362 investments in 236 separate companies. Whilst the amount raised is less than the government predicted in 1995, the average investment size (GBP517,000) and the number of companies benefiting are testimony to the success of the scheme. (Source: PricewaterhouseCoopers - Venture Capital Trusts Review - Issue 7)

Focus of Investment

As outlined above, the Act imposes certain qualifying restrictions relating to the composition of VCT investment portfolios to ensure that funds are invested into those companies that VCTs were intended to benefit and that a proportion of the investment made was genuine equity to fill the perceived equity gap.

The particular requirements are:

* at least 70% by value of a VCT's total investments must be represented by **shares** or securities comprised in "qualifying holdings" (the "70% test");
* at least 30% by value of its total "qualifying holdings" must be represented by "eligible **shares**";
* at least 10% by value of the **shares** or securities of an

investee company held by the VCT must be represented by "eligible **shares**" (the 10% test); (Note however that this requirement relates only to investments made using funds raised after 1 July 1997); and

* no holding in any one investee company may represent more than 15% by value of the VCT's total investments.

Clearly the concepts of "qualifying holdings" and "eligible **shares**" are of crucial importance and are examined in greater detail below.

Qualifying Holdings

Several requirements must be satisfied if **shares** or securities held by a VCT are to be included as part of its "qualifying holding". These requirements can be divided into two basic categories - those that relate to the size and business of the investee company and those that relate to the nature of the **shares** or securities in that company that are to be acquired by the VCT. It is not intended to examine the former category of requirements in any great detail but they broadly include the following:

* The investee company must be an "unquoted company", which in the context of the VCT legislation means that none of its **shares** or other securities are listed. The question of what constitutes a "listing" is essentially a question for the **discretion** of the Revenue. **Shares** listed on the Alternative **Investment** Market are considered to be "unquoted" for these purposes.
* The investee company must not have gross assets in excess of GBP15 million immediately prior to the investment, nor in excess of GBP16 million immediately thereafter.
* The investee company must at the time of the investment be carrying on or preparing to carry on a "qualifying trade" wholly or mainly in the United Kingdom, and the **proceeds** of the investment must also be used for the purposes of this "qualifying trade". Amongst other things, "qualifying trade" excludes activities such as dealing in land, securities or financial instruments, in providing banking, legal or accountancy services and businesses receiving a significant proportion of its revenue through royalties or licence fees this restriction can cause problems for companies that rely on research and development. The investee company must continue to comply with this requirement throughout the entire time that a VCT holds **shares** in it, or such **shares** may cease to constitute "qualifying holdings".

If it is established that a potential investee company, having satisfied the above requirements, is a suitable candidate for investment by the VCT, careful thought needs to be given to the structure of the investment itself, including the nature of the **shares** and securities comprising that investment. In particular the legislation requires that:

* a VCT is limited to a maximum "qualifying investment" of GBP1 million in any one investee company during any one tax year and during any six-month period;
* a "qualifying holding" must consist of new **shares** or securities issued to the VCT, i.e. **shares** already in issue that are transferred to a VCT would not constitute a "qualifying holding",
* an investee company must not be under the control of another company (or of another company and a person connected with that other company (a "connected person"), and there must be no pre-existing arrangements pursuant to which the investee company could be so controlled ("the control test").

These requirements, particularly the control test, have caused difficulties in structuring an investment to meet the requirements of the VCT, the investee company and any co-investors, but it has proved possible to provide appropriate and acceptable solutions.

GBP1 Million Maximum Qualifying Investment

If a potential investee company requires equity funding in excess of the GBP1 million maximum, it is possible for the VCT to stagger its investment by subscribing for **shares** in separate tranches so that the

maximum investment for the relevant period is not exceeded. Subscribing in tranches can also be a useful way of matching investment to the performance of the investee company so that any subsequent subscriptions are conditional upon certain targets or conditions being satisfied.

This solution is only of use, however, where the capital requirements of the investee company are such that the equity funding in excess of GBP1 million is not immediately necessary.

Where an investee company does require larger amounts of equity capital immediately, the solution is for the VCT to explore whether it can syndicate the investment, possibly with other VCTs. However, there are other issues to consider where syndication is involved, particularly in relation to "control" issues.

Of course, the VCT could make a non-qualifying investment in the investee company possibly by providing a short-term loan. Although such a funding would not form part of a VCT's "qualifying holding", it should not prejudice the element of the investment that does qualify. The VCT should, however, beware of breaching either the "70% test" or the "control test".

New **Shares**

Although a VCT must be issued with new **shares** in a company for such **shares** to constitute a "qualifying holding", it is nevertheless possible to organise a VCT investment so that all or part of the VCT's subscription monies are used to purchase existing **shares** in a company. This is achieved by using the same investment format that is used in MBOs. Typically, the VCT, together with the other investors and shareholders, invests in a newly incorporated company ("Newco"), which then purchases the entire issued **share** capital of the target company. The Inland Revenue requires that the assets of the acquired company are then immediately "hived-up" to Newco, a step causing few difficulties in most cases but susceptible to problems if third party consents are required to allow the transfer of important business assets, eg. property or licences.

Control Test

More demanding problems are caused by the "control test".

In general terms, a company is deemed to "control" an investee company for the purposes of the VCT legislation if it exercises, is able to exercise or is entitled to acquire direct or indirect control over the company's affairs. As this test is slightly vague in its application, VCTs should be careful to ensure that documentation such as investment agreements or new articles of association do not contain terms that might suggest that the VCT controls the company.

The legislation sets out specific instances where a company would be deemed to control another company. These are when a company possesses or is entitled to acquire:

* more than half of the **share** capital or issued **share** capital of the company or of the voting power in the company; or
* such part of the issued **share** capital of the company as would, if the whole of the income of the company were distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle that person to receive more than half of the amount so distributed; or
* such rights as would, in the event of the winding-up of the investee company or in any other circumstances, entitle that company to receive more than half of the assets of the investee company, which would then be available for distribution among the participators.

Before examining in more detail the problems caused by these tests and suggesting some solutions, it is important to mention that the legislation provides that in determining whether a company is in "control" of a company there shall be disregarded any person's possession or entitlement to acquire "relevant fixed-rate preference **shares**" in that company or any person's rights as a loan creditor of the company.

Accordingly, the "control test" should, provided the preference

**share** and/or loan rights are correctly drafted, apply only to the equity or ordinary **share** capital of the investee company.

Size of Shareholding and Voting Power

The first point to note from the "control test" is that no corporate shareholder can, on its own or with any person "connected" to it, hold more than 50% of the issued **share** capital or voting power of the investee company. An obvious issue for the VCT or any other co-investor is that a corporate shareholder therefore cannot, without breaching the "control test", pass or block ordinary shareholder resolutions of the investee company without the support of at least one other "unconnected" shareholder. As ordinary resolutions include those which increase a company's authorised **share** capital, authorise the directors to allot **shares**, appoint and remove directors, and approve dividends, it is important for a VCT to seek alternative protection. In practice this problem is dealt with by providing, usually in an investment agreement, that such resolutions will not be passed without the consent of the VCT, any other investors or their nominated representative(s), a solution that has been accepted by the Inland Revenue.

Distributions and Returns of Capital

The "control test" also provides that no corporate shareholder (on its own or with a "connected person" would, as a result of its holding of issued ordinary or equity **shares** in the investee company, be entitled to more than half of the income of the company (if it were to be distributed), or be entitled to receive more than half of the assets of the investee company on a winding-up.

Consequently, no corporate shareholder is entitled to have equity **shares** with enhanced rights in relation to dividends or return of capital if such enhanced rights would entitle it (taken together with any "connected person") to more than 50 per cent of the income or assets to be distributed.

This may not be an issue for the VCT itself if its ordinary **shares** in the investee company are "eligible **shares**" and therefore, as explained in greater detail below, not entitled to any preferential rights to dividends or to the investee company's assets on a winding-up. There may, however, be other shareholders, particularly non-VCT venture capital investors, who would expect their equity **shares** to have such enhanced rights. In particular, venture capitalists would expect to be first in the queue of shareholders on a winding-up, at least until the value of their investment had been repaid.

Clearly this is a problem for the VCT where it makes an investment as part of a syndicate of venture capital investors, as it will have to persuade its syndicate partners (to the extent that they are body corporates) to limit their own **share** rights to accommodate the restrictions imposed on the VCT.

A practical solution has been to include a provision in the investee company's articles of association effectively "capping" a corporate shareholder's rights on a distribution or return of capital so that any enhanced entitlement is subject to the status of the VCT's **shares** as a "qualifying holding" not being prejudiced. In other words, the other corporate shareholders are entitled to have the normal enhanced rights attaching to their ordinary **shares**, but such rights are limited so that no corporate shareholder is entitled to more than 50% of the income of the investee company or 50% of its assets on a winding-up.

This is not an ideal solution, but other possible schemes to resolve the problem are disadvantaged by their complexity. Representations have, however, been made to the Revenue to consider the matter further.

Eligible **Shares**

As stated above, at least 30% by value of a VCT's total "qualifying holdings" must be represented by "eligible **shares**" and, in respect of investments made using monies raised after 1 July 1997, "eligible **shares**" must comprise at least 10% of its

**shares** and securities in each investee company (the 10% test). These are defined by the Act as being:

"**shares** in a company which are comprised in the ordinary **share** capital of the company and carry no present or future preferential right to dividends or to the company's assets on its winding up and no present or future right to be redeemed".

Essentially this means that such **shares** must be plain "vanilla" ordinary **shares** without any of the enhanced rights in relation to dividends, redemption and return of capital that a venture capital investor might normally expect. Therefore, "eligible **shares**" will not be "preferred" ordinary **shares** but **shares** with the same rights in relation to dividends, etc. as the "eligible **shares**" held by management or employee shareholders (although the "eligible **shares**" held by a VCT may well be distinguished as a separate class for other reasons). Unlike the "control test", which is applied by reference to all corporate shareholders (including the relevant VCT or VCTs), the only reason why non-VCT shareholders, such as any co-investors for example, should not hold ordinary **shares** that have such preferential rights is because of any consequent effect on the "control test" arising from such enhanced rights.

Although the ordinary **shares** held by a VCT must not as a general rule be "preferred" over any other class of **share** if they are to be considered "eligible **shares**", the Revenue have applied a common sense approach in their interpretation of the legislation. For example, the Revenue have, in circumstances where the Articles of an investee company provided for the existence of "deferred **shares**" (whose rights in relation to dividends and on a return of capital were effectively worthless) stated that the existence of such deferred **shares** could be dismissed as "de minimis" and accordingly did not affect the "eligible" status of the ordinary **shares** held by the VCT. This is useful given the predominant use of deferred **shares** to implement ratchets between venture capital investors and management.

Each case will have different facts and the Revenue may well take a different view in slightly different circumstances. It may, therefore, be wise to provide deferred **shares** with rights that, although effectively worthless, are still technically in preference to the rights of the ordinary **shares** held by the VCT.

For example, the investee company's articles might provide that on a return of capital, the deferred **shares** as a class are entitled to a maximum aggregate return of GBP1, such sum to be equally divided between the **shares** of that class, but that the entitlement of the deferred **shares** to this nominal sum must be satisfied before the VCT ordinary **shares** are permitted to participate in the winding-up.

Some ratchets are structured so that the percentage shareholding of the VCT might also increase immediately prior to a sale or quotation. If the post-ratchet equity shareholding of the VCT will potentially be greater than 50%, it is arguable that the existence of such a possibility constitutes a breach of the "control test", as the wording of the test states that a person is deemed to be in control of a company if that person is "entitled to acquire" control over a company's affairs. Again, the Revenue have stated that provided the ratchet is conditional, such a provision will not, until it is triggered and the conversion effected, breach the "control test".

Conclusion

There is clearly a tension between, on one hand, VCTs seeking to protect their financial stake in investee companies and, on the other, the restrictions imposed by the Act to ensure both that the appropriate companies receive the necessary finance and that such finance is provided through long-term equity investment.

Over the last two-and-a-half years legal, accountancy and venture capital practitioners have established, and the Revenue have blessed, solutions that provide the VCTs with the protections they require to protect their investment without undermining the spirit or the letter of the legislation or, importantly, overcomplicating the investment documentation. Although such legislation is reasonably complex the investment process should, for a practitioner with experience in these areas, be a straightforward one.



**Company Names (DIALOG Generated):** Alternative Investment Market ; GBP1 Million Maximum Qualifying Investment ; Newco ; Qualifying Holdings ; Voting Power ; VCT ; Williams Committee

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72/9/17 (Item 17 from file: 268)
00339598
DOL issues guidance through informational letters
Anonymous
Trust Letter , v 391 , p 5-6 , Jun 1998 **Document Type:** Newsletter Article **Article Type:** News **Journal Code:** BTRL **Language:** English **Record Type:** Abstract Fulltext
**ARTICLE REFERENCE NUMBER: J**
**Word Count:** 01082

### Abstract:

The Department of Labor (DOL) has issued several informational letters recently: 1. letters on the use of affiliated brokerage services to First Commercial Trust Co. and Fleet Financial Group Inc., 2. a letter on the use of a single-fund family to Douglas O. Kant, 3. letters on selecting service providers to Theodore Konshak, 4. a letter on the use of a trustee's depository accounts to FMB Financial Group, and 5. a letter regarding the sale of unallocated shares in an ESOP.

### Text:

The Department of Labor (DOL) has issued several informational letters recently, and this type of guidance is useful to other banks but not always well-publicized. Many of these letters contain the Department's position on issues that are of interest to bank trust departments.

If you wish to receive a copy of any of the DOL informational letters, please call ABA's Senior Trust Counsel Judi McCormick at (202) 663-5479. Summaries of the letters follow.

Letters on the Use of Affiliated Brokerage Services

Two information letters, one dated February 12,1997, and the other dated April 28, 1997, were released by the DOL last year. One was to First Commercial Trust Company, N.A., and the other was to Fleet Financial Group, Inc. In the letters, a bank and a trust company proposed to make their affiliate's brokerage services available.

The Fleet letter dealt with the use of affiliated brokerage services on a fee basis to those plans whose investments are directed by plan

participants or independent investment fiduciaries. The First Commercial letter concerned assets that were managed by the trust company with **investment discretion**, and the brokerage service was provided without a fee but without any effect on the trust company's fees. Plan participants or independent fiduciaries would authorize the use of the affiliated broker, either under a standing authorization or on a transaction basis, and would receive 30 days' notice of any increase in fees; use of the affiliated broker could be canceled at any time without penalty. DOL found that Section 408(b)(2) would be available as an exemption from the Section 406(a) prohibited transactions, and that Section 406(b)(1) would not be violated for the reasons described in Advisory Opinion 85-15A.

Letter on the Use of a Single-Fund Family

In a DOL letter to Douglas O. Kant, dated November 26, 1997, the Department confirmed that the use of a family of funds managed by a single investment firm would not in itself constitute a breach of fiduciary duty under the Employee Retirement Income Security Act (ERISA).

Specifically, the DOL replied that a plan would not fail to meet the "broad range of investment alternatives" requirement in the Section 404(c) regulation merely by offering look-through investment vehicles that are managed by a single investment firm. DOL added that responsible plan fiduciaries are also subject to ERISA's general fiduciary standards in initially choosing or continuing to designate investment alternatives for a 404(c) plan, and the letter described the factors relevant to such determinations.

Letters on Selecting Service Providers

In a DOL information letter to Theodore Konshak, dated December 1,1997, the Department stated that, in selecting an enrolled actuary, a plan fiduciary should consider and assess all relevant factors, including quality and cost of services. Although the compensation paid to a service provider such as an actuary should be reasonable in light of the service rendered, a fiduciary is not required to select the lowest bidder. Cost is just one factor and should not be considered to the exclusion of other important factors, such as the quality of the work product.

The fiduciary should use an objective process designed to elicit information necessary to assess a prospect's qualifications and to avoid self-dealing and conflicts of interest, such as soliciting bids, although what constitutes the "appropriate method" for selecting a service provider depends on the relevant facts and circumstances (some examples of which are described in the letter). On the Form 5500, total compensation paid to a service provider for all types of services must be disclosed on the Schedule C. Although, this reporting item requires information about all individuals who receive $5,000 or more in compensation from the plan for services provided, only the primary service must be identified.

The same process was described in a DOL information letter to Diana Orantes Ceresi, dated February 19, 1998. In response to a letter from union counsel, DOL described the process and considerations that are relevant to a plan fiduciary's selection of a provider of health care services. The concern expressed by the requester was whether a plan trustee must contract with the provider that submits the lowest fee quote. Letter on the Use of a

Trustee's Depository Accounts

The DOL also released an information letter to FMB Financial Group on September 10, 1997. In the situation described, a bank serving as custodian or trustee of ERISA plans proposed to use an affiliated bank as a depository on a daily basis for ERISA funds awaiting distribution or investment. No sweep or other fees would be charged other than FMB's fiduciary fees, which would not be affected by how the ERISA funds were invested. The accounts would be FDIC-insured and pay competitive rates.

The DOL reviewed the Section 408(b)(2) exemption for the provision of services, the Section 408(b)(6) exemption for "ancillary services" provided by a bank, and the Section 408(b)(4) exemption for investments in bank deposits and indicated that all these exemptions may be available in this

situation.

DOL noted that FMB, when acting as a directed trustee, remains responsible for determining whether a given direction will violate ERISA and must ascertain in all situations whether potential conflicts may interfere with the proper exercise of its fiduciary responsibilities.

Letter Regarding the Sale of Unallocated **Shares** in an ESOP

On December 17, 1997, the DOL responded to a request for its views on the sale of unallocated **shares** held in a suspense account of an employee stock ownership plan (ESOP) to repay the outstanding ESOP loan balance following the termination of the ESOP. The Department stated that the ESOP loan would not fail to be exempt solely because the appropriate plan fiduciary used assets of the ESOP other than those enumerated in Section 2550.408-3(e) to repay the loan.

Nonetheless, continued the Department, the use of any assets other than those enumerated in that part of the regulation would be subject to the general fiduciary rules of ERISA. Finally, the Department referred to Advisory Opinion 93-35A (December 23, 1993), which stated that the appropriate plan fiduciary must consider whether the lender has a security interest in the employer securities in the suspense account (or the **proceeds** from the sale thereof) in the event of default. In the absence of a determination by the plan fiduciary that the lender has an enforceable legal interest in the unallocated employer securities in the suspense account, repayment by the plan of the balance remaining on the loan through the sale or exchange of such securities would appear to violate ERISA Sections 403(c)(1), 404(a)(1)(A), 404(a)(1)(B), and 406(a)(1)(D).



**Company Names:**
Department of Labor
Fleet Financial Group Inc **Duns:** 05-403-7254
First Commercial Corp
First Michigan Bank Corp **Duns:** 02-090-1757

**Classification:** 9190 (CN=United States); 8130 (CN=Investment services); 4310 (CN=Regulation); 6400 (CN=Employee benefits & compensation)
**Descriptors:** Brokers; Mutual funds; Investment companies; ERISA; Regulation of financial institutions; ESOP
**Geographic Names:** US

72/9/18 (Item 18 from file: 268)
00331200
BHC permitted to advise self-distributed mutual funds
Anonymous
Trust Letter , v 387 , p 6-7 , Feb 1998 **Document Type:** Newsletter Article **Article Type:** News **Journal Code:** BTRL **Language:** English **Record Type:** Abstract Fulltext
**ARTICLE REFERENCE NUMBER:** C
**Word Count:** 00564

### Abstract:

On December 18, 1997, the Federal Reserve Board approved a foreign bank holding company's (BHC) application to provide investment advisory and administrative services to a self-distributed family of mutual funds. The order is unusual in that it essentially involves a banking institution engaging in mutual fund advisory activities for funds that use neither an underwriter nor a distributor. The BHC, Lloyds TSB Group PLC of London, applied to the Fed under Section 4(c)(8) of the Bank Holding Company Act and Regulation Y to retain its indirect ownership in IAI Holdings Inc. of Minneapolis, Minnesota, and thereby engage in various nonbanking activities.

### Text:

On December 18, 1997, the Federal Reserve Board approved a foreign bank holding company's (BHC) application to provide investment advisory and administrative services to a self-distributed family of mutual funds. The order is unusual in that it essentially involves a banking institution engaging in mutual fund advisory activities for funds that use neither an underwriter nor a distributor.

The BHC, Lloyds TSB Group, plc, of London, England, applied to the Fed under Section 4(c)(8) of the Bank Holding Company Act and Regulation Y to retain its indirect ownership in IAI Holdings, Inc., of Minneapolis, Minnesota, and thereby engage in various nonbanking activities. IAI provides investment advice to institutions, pension and **profit** -sharing plans, municipalities, and individuals. It also serves as investment advisor and administrator of 25 mutual funds, 19 of which make up the IAI family of funds. Each of the funds advised and administered by IAI is registered with the SEC under the Investment Company Act of 1940.

The IAI funds do not have a third-party distributor that serves as the funds' principal underwriter for purposes of the Investment Company Act. Instead, the funds enter into selling agreements directly with various broker-dealers and rely on independent sources for advertising. The selling agreements are managed by a marketing officer who contacts brokerdealers and other financial intermediaries regarding the sale of fund **shares** and negotiates the selling agreements. The marketing officer is not an employee of Lloyds or any of its affiliates. Furthermore, the marketing officer reports directly to the mutual funds' boards of directors, which are entirely independent of Lloyds.

In the application, Lloyds made various representations regarding its relationship with IAI Holdings, Inc., and its subsidiaries. For example, neither Lloyds nor IAI or its affiliates would enter into a distribution

agreement with the funds, purchase **shares** of the IAI funds as principal, or be identified as the distributor in prospectuses or sales literature. In addition, neither Lloyds, IAI, nor any other affiliate will engage in any activity that would cause it to be considered a broker of **shares** of the IAI funds under the Securities Exchange Act of 1934, nor would they receive any transaction-based compensation in connection with the sale of **shares** of the IAI funds or enter into any selling agreements with the funds.

These representations, the Fed concluded, would make the operational structure of the IAI funds consistent with the GlassSteagall Act. The Fed also determined that the nonbanking activities proposed in the application are consistent with the "proper incident to banking" test, which requires a finding that the nonbanking activities will produce benefits to the public that outweigh any possible adverse effects.

Finally, the Fed indicated that Lloyds is subject to the Board's interpretive rule on investment advisor activities (12 CFR 225.125). Under the interpretive rule, a BHC and its bank and nonbank subsidiaries should not purchase, in their sole **discretion** and in a fiduciary capacity, securities of any **investment** company for which the BHC acts as investment adviser unless the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. The interpretive rule also prohibits a BHC from acting as investment adviser to any investment company that has either the same name as the BHC or any of its subsidiary banks or a name that includes the word "bank."



**Company Names:**
Lloyds TSB Group PLC
IAI Holdings

**Classification:** 8130 (CN=Investment services); 4310 (CN=Regulation); 3400 (CN=Investment analysis); 9190 (CN=United States)
**Descriptors:** Foreign banks in US; Bank holding companies; Regulation of financial institutions; Mutual funds; Institutional investments
**Geographic Names:** US

72/9/19 (Item 19 from file: 608)
598545 **Story Number:** 9588
FINANCIAL PLANNERS DESCRIBE HOW TO CUT YOUR TAXES NOW

Mark Schwanhausser
San Jose Mercury News (California)
Oct 08, 1997 13:58 E.T.
**Document Type:** Newspaper **Record Type:** Fulltext **Language:** English
**Word Count:** 2278

**Text:**

Oct. 8--Like it or not, your 1997 tax countdown has begun.

As of today, you have but 12 weeks left to take action to cut your taxes before one of the most complicated tax-filing seasons in more than a decade -- a headache created by the oxymoronic Taxpayer Relief Act of 1997.

"We're calling this legislation the `Financial Planners Full-Employment Act,'" said John Mueller, a tax law analyst for CCH Inc. of Riverwoods, Ill., a publishing house for professional preparers. "The Cleavers need to bring in a few more people to help them figure out their situation."

If complexity isn't a compelling enough reason to start plotting your year-end tax strategy earlier than usual, here are two more:

Opportunity and fear.

Do things wisely, and you stand to save hundreds, if not thousands, of dollars in taxes. For example, this coming April, investors can slice the tax on capital **gains,** home sellers can pocket up to $500,000 in appreciation, business owners can write off larger expenses, and small businesses and their workers can count the money they saved in the new SIMPLE retirement accounts. There are even more breaks starting in 1998 -- everything from new child and education credits to higher-education breaks to revitalized individual retirement accounts.

Do things complacently or sloppily, however, and your decisions could haunt you -- not just this coming April 15, not just on April 15, 1999, but throughout your retirement.

You must track a growing number of phase-outs that whittle down credits, deductions and exemptions. You must sidestep traps that threaten your individual retirement accounts. You must avoid stumbling into the anything-but-benign alternative minimum tax. Even the welcome news of lower capital **gains** rates can expose you to extra tax and market risk while raising questions about time-honored strategies on everything from stock options to investing in general.

"The last really big tax act was in 1986. You had a lot of change, a lot of education of taxpayers and clients....The preparation got harder in 1986 for no benefit," said Kathy Burlison, a tax research and training specialist for H&R Block Tax Services Inc. in Kansas City, Mo. "Tax preparation got harder this year, but there are lots of benefits to it."

Despite all the tax law changes, a classic tax-planning strategy remains sound: "Bunch or defer" income and deductions into the year that will cut your tax more. Indeed, the lawmakers' trend toward phasing out credits, deductions and exemptions for upper-income taxpayers makes bunching and deferring more vital than ever.

"It's as good today as it ever has been," said Leonard W. Williams, a Sunnyvale certified public accountant. "It's something real people can do."

The strategy is based on three time-tested rules of tax planning:

1.Postpone tax whenever possible.

2.Take the income tax bite when your tax bracket is lowest.

3.Funnel deductible expenses into a year when your tax bracket is high.

To execute this strategy wisely, first sketch out your taxes for both 1997 and 1998. It's important to identify income, deductible expenses and investment **gains** and losses you could judiciously pour from one year to the other.

Bunching and deferring tends to be most effective if your income is irregular and you are straddling two tax brackets -- giving small adjustments powerful leverage. It also works if your income is steady but you can regulate certain deductible expenses, bunching them every other year so they exceed the standard deduction every taxpayer is entitled to take, resulting in larger write-offs every second year.

Bunching and deferring also is effective if you are at the brink of various phase-outs or the alternative minimum tax (AMT). Among the items you might manipulate with significant effect:

Income: This includes bonuses, fees, investment **profits** and payouts from retirement plans. For instance, it might be wise to ask your boss to postpone paying your year-end bonus until January if you expect to fall into a lower tax bracket in 1998. If you're a consultant or run a business, consider waiting until January to bill customers for work you perform in December. Do so reasonably, however, so you don't report an unrealistic income flow. And make sure you understand when billings become income.

"The most common misperception among the self-employed is they get the check in December but don't cash it until January," Williams said. "The rule is, it is income once you have the check in your hot little hand and have the **discretion** to cash it or not."

Timing **investment** sales can pay off even if you remain in the same tax bracket. If you sell this year, the tax is due next April. By waiting until January to sell, you would postpone the tax bill until April 15, 1999 -- an extra year in which that money can work for you, not Uncle Sam.

Deductions: There are three classes of deductions you can move from one year to another: itemized deductions, miscellaneous deductions and medical deductions. No matter what, in 1997 you are entitled to claim at least the standard deduction of $4,150 if you file singly or $6,900 if you file jointly as a married couple. (In 1998, CCH projects those deductions will rise with inflation to $4,250 and $7,100, respectively.)

For most taxpayers who itemize their deductions, the biggest write-offs generally are mortgage interest, state and federal tax payments and charitable contributions. Itemizing is worthless until you can pile up more than the standard deduction, however.

The second tier of deductions are so-called miscellaneous deductions. These include a laundry list of expenses ranging from union dues and safe-deposit-box rentals, to subscriptions to investment publications and unreimbursed employee business expenses. The problem is you can't write off all these deductions. You can write off only the total expenses that exceed 2 percent of your adjusted gross income, or AGI. Similar logic is applied to medical expenses, except you can write off only the amount that exceeds 7.5 percent of your AGI.

Your goal is to bunch deductions in whichever year gives you the bigger bang. If that's 1997, that commonly means paying your January mortgage bill, April property tax or fourth-quarter estimated tax payments in December. If you're a landlord and your income is likely to rise next year, identify inevitable repairs you can put off until January to offset that income. If you're buying a home as the year winds down, consider closing escrow in January if the mortgage points and interest wouldn't help push you past the standard deduction. If you want to give to charity but won't have the cash until January, charge your contributions; your deduction is based on when you gave the money, not when you pay it.

Here's how bunching could work to your advantage. Say you and your

spouse own a home free and clear, leaving you with no mortgage write-off but with $2,000 in property taxes, $2,500 in state taxes and $2,000 in annual contributions to your church. All told, that's only $6,500 -- $400 shy of the $6,900 standard deduction in 1997.

One solution would be give your church $4,000 this year but none in 1998, pushing your 1997 deductions to $8,500. The church comes out even over two years, but you'd write off more than 10 percent extra -- $15,600 instead of just the $14,000 you'd get by taking the standard deductions of $6,900 in 1997 and $7,100 in 1998.

Keep in mind, however, that deductions aren't as powerful as they might seem. The actual break is proportional to your marginal tax bracket -- unlike a tax credit, which reduces your tax dollar for dollar. So resist ringing up expenses senselessly.

"Don't do something unless you were going to do it already," said Howard Lyons, an enrolled agent and financial planner who owns Lyons Financial in San Jose. "Some people work very hard trying to save taxes -- and they spend a lot of money doing it."

As effective as bunching and deferring is, there are two ways it can blow up in your face.

First, bunching can leave you holding unexpected bills for federal and state alternative minimum taxes -- especially in Silicon Valley.

The AMT is essentially a second tax system in which certain income, deductions and credits are disallowed. Taxpayers are supposed to calculate both their regular income tax and AMT, then pay whichever is higher. Among the adjustments that can snare Valley residents are certain state, local and foreign property taxes and the "bargain element" of stock options.

In addition, the AMT blunts write-offs of mortgage interest, itemized deductions, medical expenses, personal exemptions and the standard deduction. Therefore, the standard strategy of prepaying the first installment of your 1998 property tax actually could increase your AMT bill.

Second, bunching can backfire because piling up income in one year boosts your adjusted gross income. Among other things, that can limit how much itemized and medical expenses you can write off, eliminate your federal exemptions and California tax credits, expose a greater **share** of Social Security benefits to taxes and block you from making deductible contributions to an IRA.

And if you push too much income into 1998, you could become ineligible to convert an existing IRA into the new Roth IRA. Managing this decision poorly could cost you in retirement.

The cost of phase-outs isn't new -- but it is growing. That's because lawmakers were intent on limiting the 1997 tax bill's breaks to lower- and middle-class taxpayers. To do so, they imposed a tangle of differing phase-outs. (See chart, Page 13G.).

"It's booby-trapped nine ways to Sunday with phase-outs," Williams said.

Figuring out which tax break comes with a phase-out is one thing. Keeping track of when a phase-out begins and when a tax break disappears is another. But a further complication is that some phase-outs are based on different definitions of "modified adjusted gross income," which is a derivation of the AGI figure you calculate at the bottom of Page 1 of your 1040 form. For example, you might have to add back such things as losses from rental property, IRA deductions and foreign income-tax exclusions, Burlison said.

"If anyone is anywhere close...to a phase-out, I would want to look at the definition of modified adjusted gross income," Burlison said.

The phase-outs could have impact far beyond your 1040 form, too. Mueller, the tax analyst at CCH, says it's conceivable that a taxpayer would reject a promotion at work because the pay raise would eat into 1998 child or education credits and make it harder to justify the extra time and stress of the new job.

"In the past, families didn't have those kinds of issues to deal

with," Mueller said.
LOWER THAT REFUND: If you're on course to file for big refunds next April 15, cut back your withholding immediately. That way your cash will stay in your pocket, not in government vaults. If tax refunds are your illogical way of saving, then how about authorizing automatic withdrawals into, say, an individual retirement account instead?
ACCOUNT FOR THOSE KIDS:Starting in 1998, you can claim a $400 credit for every qualifying dependent age 16 and under. (It will rise to $500 in 1999.) So reduce your withholding accordingly in January to avoid an oversized refund on April 15, 1999.
PAY BILLS WITH PRETAX DOLLARS:Many employers open enrollment in November and December for flexible-spending accounts you can use to pay certain expenses in 1998. You can defer $5,000 tax-free from your pay for child care and an unlimited amount for medical bills. Project your expenses conservatively, however, because you'll lose any money left over at year's end.
PLAN YOUR GIFTS:An efficient way to pass along your estate tax-free is to give annual gifts to your eventual beneficiaries. You can give up to $10,000 per person each year. File a gift tax return (Form 709) if you give assets that are hard to put a price tag on, such as founders' stock, says Sharon Stengel of Coopers & Lybrand. Under a new law, the Internal Revenue Service has only three years to challenge the value of declared gifts. (In the past, there was no statute of limitations, so the IRS often didn't challenge valuations until the donor had died and the agency was assessing estate taxes.)
BRACE FOR A FISCAL HANGOVER ON NEW YEAR'S DAY: You max out on Social Security tax once you earn $65,400. The problem is those FICA deductions will start chipping away at your paycheck again starting Jan. 1. "The Christmas bills hit, then guess what, you come up short because you're back on the FICA trail," said Greg Finley of Mohler, Nixon & Williams. So, don't get too giddy during these FICA-free days.


**Company Names:** AMT ; Coopers & Lybrand ; CCH Inc ; H & R Block Tax Services Inc ; Knight Ridder/Tribune Business News ; Lyons Financial ; Mercury News ; Mohler Nixon & Williams ; Social Security
**Descriptors:** Banking, Economy, Personal Finance, Stocks

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72/9/20 (Item 20 from file: 267)
00031871
Giving Up Retained Earnings: a Proposal

Matthew Greco
Investor Relations Business
September 9,1997 **Document Type:** NEWSLETTER
**Publisher:** SECURITIES DATA PUBLISHING
**Language:** ENGLISH **Word Count:** 701 **Record Type:** FULLTEXT

**Text:**

It's not likely to make the top ten list of new corporate ideas any time soon, but it is provocative. And the question may be whether it makes it to

the top ten list of any shareholder activists.

In the May/June issue of the Financial Analysts Journal, the academic publication of the financial analyst's group, the Association for Investment Management and Research, an article suggests that shareholders can reclaim corporate power through a novel tax scheme.

Author Victor Morris, CFA, an investment consultant in Teaneck, N.J., offers what he calls "The Conduit Solution," wherein corporate retained earnings need not always be under management control. "A simple change in the tax law could have the effect of giving shareholders control of corporate earnings: Tax such earnings on the conduit principle, as is done with registered investment companies and real estate investment trusts."

The reason for proposing such a radical change would be to give power back to shareholders, Morris suggests, power that they lost long ago and for which the proxy process is but a pale, secondary sop.

Instead, management holds the power in the modern corporation, and much of that power is exerted through retained corporate earnings, Morris said. For 1996, for instance, there was net cash flow (including depreciation and amortization) of $662 billion at the disposal of management, he said.

Be a Conduit

A simple change in the tax law would give corporations the choice of being treated as a conduit or taxed as they are currently. Under a conduit scenario, corporate **profits** would only be taxed once, in the form of shareholder distributions, rather than twice-both at the corporate level and at the shareholder level.

The decision on how to be taxed and how to use retained earnings would be settled by a shareholder vote, Morris suggested. "The issue would be the occasion for great debate in the business community and the financial press"-which is putting it mildly.

"Management would warn that if it could not retain earnings under its control, business investment would be dealt a paralyzing blow," he writes.

But proponents of conduit treatment would argue-not unlike supply-side economics theory-that the pool of potential investment funds would actually be enlarged because corporations would not have to pay taxes, Morris said. "What we now refer to as pretax **profits** would all be available for **investment** at the **discretion** of the shareholders, who would decide how much and [in] which companies to reinvest."

That is, companies in need of capital to grow their businesses would receive it by offering dividend reinvestment plans, under which shareholder could reinvest their dividends through the creation of new **shares**. "Well-managed companies would have high reinvestment rates, and poorly managed companies would have low reinvestment rates," Morris said.

Earnings Yield Stocks

What would be other effects of such dramatic change? Morris said under the conduit plan, stock prices would reflect yields like never before because dividends would be the same as earnings yields.

"The market would classify dull, nongrowing companies as 'income stocks;' their yields would be high because their prices would be low, reflecting their limited growth prospects. Investors would be buying either a stream of growing earnings or stable earnings-the same as now, only more so," he writes.

Investors seeking capital appreciation would reinvest all of their dividends/earnings in growth companies, Morris said. "The latter would, in effect, retain nearly all of their earnings within the company, albeit after the creation of additional **shares**."

Furthermore, Morris said, "capital would be mobile; it would not be locked up in stagnant pools controlled by managements for whom it creates a temptation to stray into areas they know little about.."

Managements of mature companies do not need additional capital and shouldn't be encouraged to expand into areas of incompetence, Morris writes.

Anyone with familiarity with the sorry results of many mergers and

acquisitions might agree with Morris' assessment. But whether you agree with his hypothesis or not, one thing seems assured if the idea were ever to be looked at seriously: "Managements would be cool to the idea," he writes. "They wouldn't not want to be pressured into relinquishing control of the pool of retained earnings." Amen.



**Company Names (DIALOG Generated):** Association for Investment Management and Research ; Financial Analysts Journal

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72/9/21 (Item 21 from file: 268)
00315017
Fund manager plans offering for newly formed office REIT
Yavorsky, Sarah
Real Estate Finance & Investment , v 3 , n 27 , p 1,11 , Jul 14, 1997 **Document Type:** Newsletter Article **Article Type:** News **Journal Code:** BXRE **Language:** English **Record Type:** Abstract Fulltext
**ARTICLE REFERENCE NUMBER:** N
**Word Count:** 00385

**Abstract:**

Wells Real Estate Funds is planning to file soon for an initial blind-pool offering of an office real estate investment trust it is forming called the Wells Real Estate Investment Trust. Brian Conlon, COO, said the Houston, Texas, investment management company will file to offer 15 million shares of common stock at 10 plus an additional 1.5 million shares for dividend reinvestment for a total offering size of $165 million.

**Text:**

Wells Real Estate Funds is planning to file within the next week for an initial blind-pool offering of an office real estate investment trust it is forming called the Wells Real Estate Investment Trust. Brian Conlon, coo, said the Houston investment management company will file to offer 15 million shares of common stock at 10 plus an additional 1.5 million shares for dividend reinvestment for a total offering size of $165 million. The blind-pool offering, which analysts said is rare and somewhat risky, is expected to come to market in the next 60-90 days.

Blind-pool offerings, which do not specify the properties the general partner plans to acquire, are considered risky investments as investors are giving the **investment** firm complete **discretion** over the fund's activities, analysts said. Unless an investor is very comfortable with the **investment** firm, "I don't think they're worth the risk," added Lou Taylor, senior analyst at Prudential Securities. Conlon said that Wells has sold interests in 10 partnerships with a market value of $20-40 million each through such offerings.

Wells Investment Securities, the company's investment banking subsidiary, will underwrite the offering, which will be distributed through

independent broker dealers such as New England Securities, Chubb Securities and Transamerica Financial Resources, the same network Wells uses to market its other products, Conlon said. The REIT will not be listed on any exchange until it has a stable operating history, which will probably take three to five years. In the meantime, investors will have to hold onto their **shares**, he noted. The REIT will target dividends yields of 6-8%.

The REIT has yet to acquire any assets as it is looking to put itself in a strong negotiating position by conducting business on an all-cash basis. With **proceeds** from the sale of stock, Wells REIT will acquire six to eight suburban offices at an average cost of $15-25 million each, Conlon said. Specific properties have not yet been lined up, he said, adding that investors will be buying stock based on Wells' past performance and strategy. The fund manager focuses on buildto-suit properties net-leased to Fortune 500 companies, such as General Electric, IBM, BellSouth and Lucent Technologies, and has spent roughly $50 million over the last 12 months. "Now we will buy [these] properties for the REIT entity as well," he said. -S.Y.



**Company Names:**
Wells Real Estate Investment Trust

**Classification:** 8110 (CN=Commercial banking); 8360 (CN=Real estate); 3400 (CN=Investment analysis); 9190 (CN=United States)
**Descriptors:** REITs; Investment advisors; Going public
**Geographic Names:** US

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72/9/22 (Item 22 from file: 268)
00312732
Mortgage lender opportunity and peril
Muldavin, Scott R

Real Estate Finance , v 14 , n 1 , p 5-9 , Spring 1997 **Document Type:** Journal Article **ISSN:** 0748-318X
**Journal Code:** RFN **Language:** English **Record Type:** Abstract Fulltext
**ARTICLE REFERENCE NUMBER:**
**Word Count:** 03261

## Abstract:

Commercial mortgage lenders, like their residential counterparts, have historically struggled to produce consistent profits due to cyclical lending volume caused by swings in interest rates and other factors. Today, the challenges facing commercial mortgage lenders have mushroomed because of the emergence of new competitors and increasingly frequent changes in competitor strategies. However, while mortgage lenders face greater challenges and complexity, broad market opportunities increase the profit potential for the most successful lenders.

## Text:

Commercial mortgage lenders, like their residential counterparts, have historically struggled to produce consistent profits due to cyclical lending volume caused by swings in interest rates and other factors. Today, the challenges facing commercial mortgage lenders have mushroomed because of the emergence of new competitors and the increasingly frequent changes in competitor strategies.

While mortgage lenders do face greater challenges and complexity, broad market opportunities increase the **profit** potential for the more successful lenders. The emergence of the commercial mortgage-backed securities (CMBS) markets in the 1990s presents a strong opportunity for financial institutions who are less interested in retaining loans on their balance sheet and more interested in origination fee and servicing income. The evolution of financial institution regulation has increased the ability of lenders to achieve broad market penetration, and technological advances - including the Internet -create significant distribution possibilities for lower-cost or "niche" mortgage providers. Enhanced knowledge of the motivations, regulatory issues, financial conditions, and the overall business environment of clients and competitors is critical to navigating the future.

Mortgage conduits, pension funds, mortgage REITs, and credit companies, among others, are active participants in the mortgage lending business, carving out niches and encroaching upon the traditional markets of banks and life insurance companies. Commercial banks, once almost exclusively construction lenders, now lend in all phases of the real estate life cycle. Insurance company appetites for mortgages have been affected by risk-based capital requirements. Most importantly, the volumes, products, and strategies of all mortgage lending participants have been changing at a much more frequent rate than they did in the past.

To address this increasingly complex environment, financial institutions and other lenders need to adopt a more strategic approach to markets and products, like the consumer product or technology industries, which have been defined historically by volatility, changing consumer preferences, and new competitors. Basic to the identification and practical implementation of strategy is industry knowledge and experience, and the rest of this article provides a select summary of real estate capital market knowledge to enhance that decision-making process.

Wall Street

The investment trajectory hurtling away from the life companies and

toward Wall Street has accelerated. It is remarkable to note that capital users uniformly now feel "the Street" has assumed a more commanding role as the source for real estate capital. That Wall Street now dominates the industry was unthinkable as recently as two years ago, but this sentiment is undeniably quantified in our survey findings, as well as by industry feedback heard at recent conferences.

Wall Street's influence has resulted in a number of positive changes. It has been the single biggest factor pushing the market to "commoditization," as it has driven a greater use of, and sophistication in, the CMBS market. More importantly, in the longer term, real estate will no longer trade on its own "offBroadway" capital markets competing only with other real estate assets. In the very near future, we believe all the capital markets will collapse into one mainstream, mainline vehicle. Accordingly, real estate assets will be priced and invested in against a plethora of hard and soft asset investments available to a chief investment officer. (Financing Notes, Cohen Financial, December 1996.)

The Debt Markets

The growing dominance of Wall Street is extending beyond the REIT, CMBS, and private placement marketplace. Nomura has become a successful direct lender, investing billions of dollars in the mortgage markets. More recently, CS First Boston has made strong inroads into the mortgage markets, originating approximately $4 billion in a variety of deals, including hard-to-finance deals. Hard-to-finance deals include those where there is a significant shortage of capital because of past problems, analytically complex deals, deals that are difficult to understand, or deals that are out of favor.

CS First Boston also lent about $1.5 billion in interim financing, which provides short-term financing to borrowers that plan to reposition properties before applying for permanent financing. In 1997, CS First Boston is expected to pursue more standard permanent loans, but even these loans are likely to include more flexible prepayment or amortization schedules or other structural nuances. (Commercial Property News, February 16, 1997.)

The significant shifts in the real estate debt markets are broadly illustrated by an analysis of the commercial mortgage origination market **share** between 1980 and 1995. For example, life insurance companies, which in 1980 had a 15.6% **share** of the mortgage market, fell to 7.1% in 1995. Banks and mortgage companies, on the other hand, grew from a 58% market **share** in 1980 to over 80% in 1995.

The savings and loan and mutual savings bank market **share** dropped the most significantly, from 17% in 1980 to around 5% in 1995. Interestingly, pension fund market **share** in the debt market actually declined from 1980 to 1995, although pension funds have never represented more than approximately 1% of the total debt market. (The Roulac Capital Flows Database, 1996.)

New inflation-linked bonds offer some equity real estate advantages. The Treasury issued $7 billion in inflation-linked ten-year U.S. Treasury notes early in 1997. The bonds carry a coupon rate of 3.375%, but are designed to minimize inflation risk, as their principal fluctuates with inflation. When the bond matures, investors will receive an amount that has the same purchasing power as the original investment, no matter how much the inflation rate has risen. This inflation-adjusted principal, however, won't be paid in cash until maturity. According to an analysis by KCM Investment Advisors, the inflation rate over the life of the new bond would have to be at least 3% for it to have a better performance than a standard ten-year Treasury bond with a coupon rate of 6.5%. (Orange County, California Register, January 29, 1997; Institutional Real Estate, Inc., February 14, 1997.)

Another example of specialized financing availability is the alliance between Daiwa Finance Corp. and Legg Mason Mortgage Capital, who have teamed up in a joint financing program targeting single-tenant net leased properties nationwide. The program offers up to 100% financing for

properties net leased to investment-grade and below-investment-grade tenants. Eligible leases include bond, triple net, and double net leases. Debt service coverage as low as 1.0x is available for loans secured by bond-type leases. Eligible loans range from $1.5 million to $100 million. (PR Newswire, February 10, 1997.)

Despite the net outflow of real estate debt capital from the insurance industry, due largely to portfolio-level sales and mortgage maturities, the insurance industry is still actively targeting the commercial mortgage sector. Early in 1997, Prudential Insurance Company announced that it expects to originate as much as $2.5 billion in commercial mortgage loans in 1997, a jump of 19% over the $2.1 billion originated in 1996. Prudential is moving aggressively in the mortgage market, not only because of the continuing recovery of the real estate markets, but also because of the expectation that risk-adjusted returns on mortgages will be very competitive compared to many other asset types.

The move toward smaller mortgages is also occurring in the insurance industry. Prudential states that as much as 50% of their 1997 mortgage volume could be originated through Prudential's PruExpress program, which handles loans from $2 million to $20 million. (Real Estate Forum, February 1997.)

Real Estate Securities Activity

Mergers and acquisitions picked up steam in early 1997 in the REIT marketplace. United Dominion Realty Trust's merger with Southwest Property Trust and the pending merger between Camden Property Trust and Paragon Group are two examples of such activity. Office and industrial REITs, with large percentages of pension fund investors, are interested in buying more real estate operating companies through trades for stock and partnership units. Securities swaps stretch the buyer's cash and give the acquired entity powerful incentives to maximize yields from their former holdings. (Crittenden's Pension Funds and Real Estate, January 1997.)

In another sign of continuing REIT mergers, Union Property Investors, Inc. shareholders have approved the proposed merger with, and into, a wholly owned subsidiary of Kranzco Realty Trust. Kranzco's purchase price of approximately $65 million was funded through mortgage debt, the issuance of preferred **shares**, and cash. (Business Wire, February 27, 1997.)

REIT performance was spectacular in 1996, posting a total return of 35.3% for equity REITs, far outpacing the S&P 500, which posted a 23% total return over the same period. In 1997, REIT returns of 12% to 16% are expected. Keys to outperforming the broader REIT indexes will be to focus on select stocks and themes and to look beyond REITs to selected real estate operating companies and home builders. (Institutional Research, Robertson Stephens & Company, January 14, 1997.)

Real estate mutual funds continue to prosper in 1997. Investors poured $1.3 billion into real estate mutual funds in January, bringing net inflows to $4 billion for the twelve-month period ending that month. Total assets in real estate mutual funds stood at $8.1 billion at the end of January. The large inflows are the result of the strong performance in 1996, as well as the specific performance of real estate stocks during the market volatility in July and August 1996, providing some evidence that REIT stocks have a low correlation with the stock market, and can thus serve as a hedge against a stock market downturn. (Real Estate Finance and Investment, March 3, 1997.)

The CMBS market matured from its infancy in 1996 to take its place as a real estate sector within the fixed-income markets. New-issue volume soared to a record of almost $28 billion, and more importantly, deals backed by newly originated loans represented about 54% of the market.

For 1997, CMBS is expected to continue to gain market **share** of new origination commercial mortgages. Regulatory pressures, targeted investment strategies, and the liquidity benefits of CMBS will continue to win converts from traditional lenders. Other expected trends are an increase in lease-backed deals, international deals, and deals backed by

increasingly smaller loans. (Commercial Real Estate Quarterly, Nomura, January 9, 1997.)

An answer to whether it pays to buy quality in the REIT marketplace was addressed by Everen Securities. Based on their research, investors are almost always better off buying "higher"-quality companies - the growth stocks of the real estate world - even when they carry loftier valuations. Since 1992, the higher-quality companies have provided a cumulative total return of about 150%, which is 50% better than the lower-tier companies. There are many interrelated factors that would drive them to this conclusion, but they believe two factors are clearly dominant.

First, companies with a low cost of capital can almost endlessly use their competitive advantage to increase their asset base. This, in turn, will generate above-peer group funds from operations (FFO) growth, which justifies premium multiples. The second factor is that successful companies tend to attract, or hire, successful people. Success begets success. ("Does It Pay to Buy Quality?" Equity Research, Everen Securities, March 3, 1997.)

Real estate mutual funds represented nineteen of the twenty top-performing mutual funds for the fourth quarter of 1996. CGM Realty Fund topped the list, with a 22% return for the quarter and a 44.1% gain for the year. On average, real estate mutual funds returned 15.9% last quarter and 30.8% last year. By comparison, the average general equity fund gained 5% in the fourth quarter and 19.5% for the year. (Dow Jones, January 13, 1997.) Pension Funds

Pension fund investment in real estate is in the process of being restructured. Over the past three years there has been a major shift from private operating companies to public ones in the real estate industry. The signs that pension funds are changing their approach are clear. CalPERS, one of the largest pension funds in the U.S., with over $100 billion in assets, has issued a new strategic plan that stresses a closer alignment of interest between the sponsors and real estate investment managers. Last summer, CalPERS announced plans to sell or swap its $1.8 billion worth of real estate holdings for **shares** in either private or public REITs. In October 1996, the $14 billion State of Connecticut Trust Funds announced plans to sell its entire $ 450 million interest in twenty-seven separate commingled funds, with the intent to transfer some of the **proceeds** into public REIT **shares**.

While the move of pension assets into public real estate companies is a critical trend, an equally critical issue is the realignment of interests of real estate investment managers and pension investors. There is general agreement in the industry that a change needs to be made so that the portfolio management function is separate from the asset management function. This is key for two reasons.

First, the portfolio managers need to make buy/sell decisions without having to worry about any negative impact on their own firm, and, second, effective asset management requires staff who are specialists in an area and property type. Even if the portfolio management and asset management are not separate, as in larger organizations that are capitalizing on their economies of scale, the structure of the relationship between pension funds and investment managers is changing, with performance-based fees and explicit exit strategies being the norm.

REITs offer an attractive option for pension funds because they facilitate the separation of portfolio and investment functions from the asset management functions, although this separation can create a problem of aligning ownership and management interests. This issue will receive a lot of attention in the coming years. ("Restructuring Pension Fund Investment in Real Estate," Thomas Black, Urban Land, February 1997.)

CalPERS has issued its first request for proposal (RFP) under its new strategic plan designed to align the interests of management with its own. While CalPERS provides a lot of flexibility for respondents and their proposals, they are encouraging respondents to consider the following: a dedicated, professional staff to work exclusively on the CalPERS account; co-investments with CalPERS; linking the incentive compensation of key

investment professionals to the relative performance of CalPERS investments; and creating incentives for key personnel to maintain continuity. Respondents can range from limited-liability corporations to REITs to partnerships to a structure that provides for direct ownership by CalPERS with management services provided by the respondent under an **investment** management contract. Respondents will have **discretion** "within a box"; however, CalPERS retains the right under all circumstances to trigger the sale of any asset from the portfolio to ensure the fund can control the exit strategy (Institutional Real Estate Newsline, March 3, 1997.)

The evidence of entity-level investment by pension funds in private real estate operating companies is growing. The $55 billion New York State Teachers Retirement System, for example, recently invested $50 million in Donahue Schreiber Realty Group, a Newport Beach, California, shopping center operator. Entity-level investments are attractive in part because they align the interests of investors and managers as both own **shares** in the real estate operating companies. Pension fund investors are interested in this type of investment because they are more familiar with financial assets, such as stocks and bonds, than with real estate. To compensate for the loss of liquidity, these deals are usually priced at a discount of 20% to 25% to a comparable REIT. (Real Estate Finance and Investment, March 3, 1997.)

The Business Environment

In a surprising strategic finding, information technology (IT) was found to be one of the most important strategies for surviving and thriving in the increasingly complex and competitive business environment, according to a recent survey of 150 senior executives of Fortune 1000 companies sponsored by Deloitte & Touche LLP. IT was considered a major driver of globalization, more so than competition or other economic factors. The movement to a global economy was seen to require instantaneous reaction, which can only be accomplished with substantial information technology investment. Over 80% of the senior executives surveyed viewed IT expenditures as a strategic investment, compared to only 15% who believe IT is a cost that has to be managed. (Pro Topics, Deloitte & Touche LLP, January 1997.)

The explosion of commerce on the Internet has, you guessed it, created a new area of law and legal consideration. In the real estate capital realm, the Securities and Exchange Commission is now developing regulations concerning the presentation of information on the Internet relating to real estate investment trusts, private placements, and the initial public offerings of real estate companies. These regulations will address the issue of when sponsors cross the line with inappropriate offering material.

In the meantime, a number have developed sample warning statements that attempt to make it clear that their on-line presentation, or trading activity, is for certain limited audiences and interested parties only, and that all readers should refer to applicable state law and regulations. Clearly, this type of statement is only one step in securities law compliance and must be done in conjunction with careful analysis by legal counsel. ("Legal Issues -Real Estate and the Internet James MacCrate, CRE, Audrey Roth, Real Estate Issues, December 1996.)

A recent U.S. District Court opinion that questions the legality of yield spread premiums demonstrates the importance of legal and regulatory factors for capital formation and related services. Yield spread premiums are a customary way for mortgage wholesalers to pay mortgage brokers for delivering loans. If the wholesaler is willing to make a thirtyyear mortgage loan at 8% and the mortgage broker charges the borrower 8.5%, the wholesaler pays the broker a percentage of the extra interest, or spread, above the 8% rate. If the judge's opinion holds, it will transform the way the mortgage industry compensates mortgage brokers and correspondents. (Origination News, February 1997.)

Moderation is the continuing theme for the economy and interest rates according to economists from the Mortgage Bankers' Association. They see

the economy growing moderately and expect it to continue in 1997. Price and wage increases are gradually creeping up, and they anticipate moderate tightening actions by the Federal Reserve that would increase the federal funds rate by 50 basis points by year-end. Long-term interest rates are expected to move up in response to the anticipated increase in short-term rates, with the thirty-year Treasury bond staying just under 7% for most of the year. (The Mortgage Bankers' Association Newsletter, January 1997.)

Federal regulatory changes in the financial services industry will continue to strongly influence the real estate capital markets in 1997. Financial services modernization issues, including Glass-Steagall Act reform and the merging of the bank and thrift charters, are expected to be addressed in the next session of Congress. Even in the absence of legislative reforms, federal banking regulatory agencies such as the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board have pushed ahead with regulatory reforms that could have a significant impact on the financial services marketplace.

Among other steps, the OCC in November 1996 announced that national banks, on a case-by-case basis, could enter a wide range of new businesses, including securities, insurance, and real estate sales. The Fed, meanwhile, announced a proposal that would allow bank subsidiaries operating under Section 20 of the Glass-Steagall Act to derive as much as 25% of their total revenue from underwriting and dealing in bankeligible securities, raising their limit from its current 10%. ("National Policy in Real Estate: What's Ahead in 1997," Urban Land, January 1997.)

Conclusion

The high level of activity and change within the real estate capital markets is a sign of health. The confidence of capital providers is being demonstrated by risk-taking new ventures and business, rather than by abandoning underwriting or acquisition standards. In the coming year, however, further attention to the "controls" in the real estate capital markets will be warranted.

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A Magic Year for Fees

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"It will be very difficult for Wall Street to continue such a revenue stream," says Edward Garden, equity syndicate chief for BT Securities.

Still, the year was one that will likely inspire fond memories for some time to come. Total disclosed fees in 1996 leaped almost 39% to $9.2 billion from $6.65 billion in 1995. (The previous record was $9.16 billion in 1993.) The average fee edged up to 1.57% from 1.36% in '95. Wall Street collected fees on some 4,618 deals in 1996, up 16% from the 3,995 in 1995.

Meanwhile, the debt side also saw steady, if less spectacular, improvement in 1996, registering a 15% hike in total fees collected as the average fee on debt deals nudged up to 0.559% from 0.547%.

The debt sector saw increases across the board, as total fees rose in every sector from investment-grade to asset-backed.

Bankers earned lucrative fees on both high-yield and emerging markets deals, in which sovereigns and corporates alike paid to get well-executed deals done in the U.S. and globally. First-time issuers were another boon for fees, debt market sources say, as some less savvy issuers, Wall Streeters admit, occasionally paid more for a deal than if they had squeezed a little harder on the market.

Syndicate officials said trust preferred securities were the biggest cash cow of any single type of debt security last year. They became all the rage with issuers after the Federal Reserve's decision in October to qualify the instruments as Tier I capital for bank holding companies. About $15 billion to $20 billion of trust preferreds were issued in the window from mid-November until the end of the year.

Sources say that lead managers earned an average of 1% to 1.125% per trust preferred issue - that translates to $150 million to $200 million in fees, of which Morgan Stanley & Co. and Goldman, Sachs & Co. were the prime beneficiaries. Some companies paid as high as 2% to 2.5% for their trust preferreds, one market source discloses, though those cases were rare.

The fact that Wall Street could book such a high volume of fees runs almost counter to the debt markets' prevailing gross spread trends. Few would argue that issuers have been chipping away at fees and spreads over Treasurys since 1993, since the supply-demand relationship in the debt markets is still largely favorable to the issuer. Certainly, no debt syndicator pretends to be making money off a plain-vanilla corporate bond for an investment-grade company, and in fact, would say it's getting harder to command decent fees for even lower-rated names.

"That kind of business is competitive, where a company will go out to six or eight firms to get the best pricing," says one syndicate official. "Some people are willing to fall on their swords to do league table business."

That's played out well for some companies. Other issuers, one debt official says, are less obvious about their efforts to drive down fees. "They'll let you know indirectly that they are talking to other firms, but they'll insist they're doing a negotiated deal with you."

Certainly, the trend toward competitive bids continues as more issuers realize their controlling position in the market. Bond sources note that pricing pressure is highest on double B- and single B-rated names, where there's still room for compression. "All an issuer has to say is 'I'm sensitive to price,' then people will show them fees through the current levels," the debt official said. "They know that people won't walk away from a deal if they aren't getting full fees, so they'll push."

Given all this fee pressure, how did bond desks make so much money last year?

More structured deals, especially high-yield bonds, continued to feed fee business. Debt officials emphasize that issuers know that you can't scrimp on nickels and dimes when you're looking for structuring and distribution expertise. Whether that's true or not, fees on high-yield bond issues were stable, and the M&A-related business done last year kept volumes up. Fees there were steady also. On the year, high-yield issuance hit $73.8 billion, surpassing all previous records for what is admittedly one of Wall

Street's most profitable businesses.

Hidden in that number is a deal for Mexico, one of the big fee generators for issuers last year. Sovereign issuers like Mexico were willing to pay their lead managers well for certainty of execution, and for the additional risk the firms were taking on. That helped Mexico, which increased its offering last summer to $6 billion and was able to tap the debt markets later in the year at cheaper relative pricing.

Emerging market issuers, in general, paid higher fees on their bonds, not surprising given that some credits around the world are new to the capital markets, or at least not well known. They are hoping that their inaugural deals will lead to greater market visibility and cheaper financing down the road, debt officials said, so they were willing to pay extra last year.

Likewise, some new issuers were paying at market or above market fees for their deals, in some cases, because of a lack of sophistication. "Some issuers saw that the all-in interest rates they were getting were phenomenal," says a debt official. "There response was 'I don't care what I pay you, if I can get the deal done at that spread level.'"

Will that continue? Unlikely, given the companies' growing knowledge of the bond market's workings, and the fewer opportunities out there to bring in first-time bond issuers.

The defining word in equity underwriting fees last year: Volume.

The rush to push equity deals out the door resulted in stiff competition, as corporate clients enjoyed a sellers' market that allowed issuers in many cases to dictate terms to investment bankers.

The tremendous inflow of money into the equity market is both good news and bad for bankers. On the one hand, it bolsters the bull market, keeps the deal pipeline full-to-bursting, and spurs competition. On the other, sources say, it can spur competition so intense that it fosters a "volume mentality" among larger firms to keep churning out deals in order to keep the money flowing in.

"There are firms out there that will cut corners," says one equity source. "They will give the company a higher valuation than warranted just to get the business."

Indeed, competition on valuations rather than fees has become a trend in itself, several sources say. "Issuers of IPOs are more interested in valuations, and some banks will inflate valuations just to get the business," another equity official says.

Some banks also create built-in incentive fee structures for IPOs. If a deal goes out on the high end of the range, the bank gets a high fee, one source explains; if it goes out on the low end of the range, the bank gets a lower fee. "The problem with that is that the bank can get penalized if the market changes," he adds.

BT's Garden says he is surprised that fees have not been pounded down even more given the excess capacity of the equity market. "In total, you still get about 7% for an IPO, and 4.5% to 5% for a secondary offering," Garden says. "The pressure the banks have seen is light compared to what it could be."

But not all agree that fees have been hammered down. Richard Smith, head of equity syndicate for Montgomery Securities in San Francisco, says fees have not drifted down too dramatically, although competition has eroded pricing on the margins. "If fees per transaction are down, it's because there are more managers, more slices of pie, and more research following more companies, and that all has to be paid for," he says.

One equity pro adds that he saw only a "modest" erosion of the fee percentage during the year, and he predicts investment banks will "hold the line" on fees.

Garden says the pricing pressure is sure to get more intense if large banks like Chase Manhattan, Citibank, First Union, and NationsBank join the equity underwriting fray in earnest. "There is a perception of better execution among the larger investment houses, but soon-if everybody can do the trading, underwriting, etc., that the big firms do-pricing pressures

will be even more dramatic," Garden says.

The bulge bracket firms may find themselves in a situation not unlike a brand name on a supermarket shelf. Just as a generic or private label canned food cuts into the **profit** of a brand name like Dole or Del Monte, the bulge firms will similarly see their **profits** whacked. "The perception that you need a big-name underwriter to do your deal is starting to dwindle, and within the next ten years, the large banks could get an expanding piece of this market," Garden notes.

For the smaller investment bank, the squeeze has not been as severe. John Lane, managing director in the equity syndicate for Westport Resources, says he still sees double digit fees-up to 15% for deals below $10 million.

Lane says smaller investment banks will commit much more strongly to a deal, often taking warrants as part of their fee. "We get in on deals with Goldman Sachs or Hambrecht & Quist, but it's mainly for the visibility, since we don't make as much on fees," Lane explains.

Non-fund IPOs enjoyed their best year ever, with a total of just under $3 billion collected on an average fee of 6.012%-a still-healthy margin, though down from the 6.222% a year earlier.

Among the most interesting trends in a market that has cooled since last fall: an increase in the number of firms underwriting IPOs.

A syndicate source at Hambrecht & Quist LLC says: "From our point of view, while the gross spread has remained intact, the number of people working on each deal has gone up."

The H&Q source adds that the more firms involved, the better for both underwriter and issuer. Having more firms work on the deal is a boon for issuers, agrees Robert Brown, executive vp of capital markets at Rauscher Pierce Refsnes Inc., since that means more research and marketing for the offering. "You'll notice that when Wall Street firms do their deals, they never have just one underwriter," Brown points out.

One analyst says that the increase in the number of underwriters per deal has been across the board. Big-name deals tend to attract more underwriters, according to Randall Roth, an analyst with Renaissance Capital Corp. in Greenwich, Conn.

"There is an automatic brand name (with high-profile deals)," Roth says, pointing to Vail Resorts Inc. as one example. Vail Resorts, which went public earlier this month after about eight months in registration, boasted Bear, Stearns & Co., Furman Selz, Goldman, Sachs & Co., Salomon Brothers, Schroder Wertheim & Co. and Smith Barney as underwriters.

The bigger the profile, the more intense the competition to get a piece

Underwriting fees in the mortgage-backed securities market were once again disappointing, totaling just over $10 million last year, compared with nearly $23 million in both 1994 and 1995, according to Securities Data Co.

The decline reflects the continuing slump in business, at least compared with early 1990 levels, and the fact that most of the deals are standard-issue transactions, which generate little in the way of fees for Wall Street.

"I have seen fees coming down because a number of newer transactions in 1996 are repeat business," says Chuck Ramsey, co-head of taxable fixed-income at Structured Capital Management in Burlingame, Calif. In fact, Ramsey predicts that fees, particularly on "B" and "C" credit-type deals in the MBS market, will decline by as much as 25% this year. "The driving force is that they are repeat deals," he said.

Despite the downturn in volume, the MBS business has also seen a few newcomers-like regional brokerage houses-that are making underwriting more competitive. And that, in turn, drives down fees, because regional dealers will work for less because of their lower overhead.

The asset-backed securities market, on the other hand, continues to see its revenue from fees increase. Total ABS fees came to about $387 million last year, compared with roughly $328 million in 1995 and $224.5 million in 1994.

"As the market gets bigger, it's more competitive," says Jeff Salmon, vp and head of ABS research at UBS Securities L.L.C. The biggest pressures have surfaced in the credit-card and automobile-loan sectors, where transactions are "plain vanilla." "In credit cards, everyone understands the structures...so underwriting fees have come in dramatically," Salmon said. (In ABS as a whole, the average fee edged down to 0.307% from 0.330% in 1995.)

Outside of these "commodity" assets, fees are still a little more attractive, particularly in the 144A market, Salmon and others say.

But while the MBS market may have seen a few new regional players surface, the ABS market is still dominated by large Wall Street firms looking to make a buck.

"The preference for issuers is to deal with three or four banks," Salmon said. "The up-and-coming small guys don't have a prayer's chance."

Bragging rights over M&A fees are sometimes shushed by **discretion** as **investment** banks opt to withhold disclosing their annual charges to clients. That can make for an anomaly in the disclosed fee totals.

Case in point: The disclosed fees by the top 15 M&A firms for transactions completed in 1996 with U.S. targets added up to $947.1 million, down from the $1.008 billion disclosed in 1995.

That seems to fly in the face of reason, since the total value of M&A deals involving U.S. targets last year added up to at least $657.4 billion compared to 1995's then-record total of $522.3 billion.

However, it's important to note that the tally for 1995 was originally announced as $786 million. The newer amount for 1995 fees, cleansed of imperfections and totaled by Securities Data Co. at the end of 1996, revealed an increase of $213.8 million more than than previously reported by investment banks.

The disclosed M&A fees for 1994 totaled $688.3 million.

Thus, it is quite possible-even likely-that even though industry participants will have to wait awhile for all the fee announcements to trickle in, at the end of the day total M&A fees disclosed for 1996 will exceed the billion-dollar figure reached in 1995.

The amount of fees paid to M&A advisors has remained fairly constant since the late 1980s, the era of the financial buyer. Fees have tended to be somewhat higher on the sell side, and slightly lower on the buy side.

"Once you take out all the leveraged buyouts and all the hostiles, the [M&A] fees are in line with what they had historically been," one banker says. "Especially in deals below $1 billion."

(According to a study by J.P. Morgan, the average target fee in 1995-

But at the same time, acquisitive companies are under increasing **share**-holder pressure to reduce or eliminate M&A advisory fees. Investor Warren Buffett is renowned for his aversion



**Company Names (DIALOG Generated):** ABS ; Bear Stearns & Co ; BT Securities ; Chase Manhattan ; Citibank ; First Union ; Furman Selz ; Goldman Sachs & Co ; H & Q ; Hambrecht & Quist LLC ; IPOs ; M & A ; Montgomery Securities ; Morgan Stanley & Co ; NationsBank ; Rauscher Pierce Refsnes Inc ; Renaissance Capital Corp ; Salomon Brothers ; Schroder Wertheim & Co ; Securities Data Co ; Smith Barney ; Structured Capital Management ; Vail Resorts Inc ; Westport Resources

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At The Agencies

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OCC/Fed

Electronic Banking

Banks wanting to **share** the cost of electronic banking can now join the Integrion Financial Network bandwagon and become another member of the North American 16-bank and IBM consortium recently approved by the OCC and the Federal Reserve.

The new partnership, located in White Plains, N.Y., received the necessary regulatory approvalofrom the Fed on Dec. 2 and from the OCC Jan. 6oto develop a range of interactive banking and electronic commerce services, including telephone banking, ATMs, and PC-based products. Because starting up something as complex as electronic banking services can be costly, this is a way for institutions to cut costs and **share** in the **profits**.

Fleet Financial, Boston, Mass.; NorWest Corp., Minneapolis, Minn.; and Royal Bank of Canada, Montreal, will be some of the key players in the new consortium. BancOne, Columbus, Ohio, and NationsBank, Charlotte, N.C., will be the first two institutions to launch pilots this year.

Banks involved in the partnership represent 60% of the retail banking business in North America. Thus, many more households will have access to the Internet and other electronic banking services, which could speed up regulations of the developing area of electronic commerce in the coming year.

OCC

Strategic Plans

The OCC plans to approve a few CRA strategic plans next week, an agency representative told RCW. The agency is following in the footsteps of the Federal Reserve and the FDIC, which approved a bank each in December for strategic plans.

Examiner Handbooks

The OCC recently released an examiner handbook on Truth-in-Lending and will distribute one on derivatives later this month, said an agency spokesperson.

Fiduciary Activities

The OCC published a final rule in the Dec. 30 Federal Register that revises its regulation governing fiduciary activities of national banks, including collective investment funds.

The final rule, effective Jan. 29, applies if the national bank serves in specified traditional capacities and is engaged in an activity where it exercises **investment discretion**.

Also, the rules apply if a national bank provides **investment** advice for a fee.

The final rule reflects the prior OCC interpretation that national bank fiduciary powers are the same for out-of-state national banks as for in-state banks. The rule's approach to multistate fiduciary activities recognizes that national banks will increasingly conduct fiduciary business in multiple states, and puts national banks on a par with competing fiduciaries in the states in which they operate.

Here are some of the key provisions:

Limits on Investment and Participation. The rule eliminates the previous limit on common trust funds, a type of collective investment fund, that limited one account to no more than 10% of a fund. The final rule also eliminates the limitation that one investment can't represent more than 10% of the investments in a common trust fund.

Modern Fiduciary Operations. The final rule permits an audit committee of an affiliate to serve as a national bank's fiduciary audit committee. This change facilitates centralization of fiduciary audit functions and accompanying efficiencies within a bank holding company structure.

The rule also allows a national bank to use personnel and facilities of affiliates to perform services related to the exercise of its fiduciary powers, and allows the bank to enter into agency agreements with other entities to purchase or sell services related to the exercise of its fiduciary powers. These changes allow banks to centralize fiduciary-related services, or to outsource them, where appropriate.

Moreover, the rule provides an exception to the collective investment fund "exclusive management" requirement to allow a bank to prudently delegate responsibilities to others.

Pledging for Fiduciary Deposits. When fiduciary cash is awaiting investment or distribution, a national bank may deposit the funds in its deposit account if the national bank pledges bank assets to secure the deposit.

The final rule also permits a national bank to pledge assets to secure deposits of fiduciary cash awaiting investment or distribution with an affiliate when not prohibited by applicable law. This standard allows a state to prohibit this practice for all fiduciaries in the state, including national banks, yet gives a national bank flexibility for its fiduciary operations in states that don't choose to impose this prohibition. This change will facilitate more efficient fiduciary operations in multi-bank holding companies.

Advertising. The rule retains the existing OCC interpretation that national banks can't advertise the performance of common trust funds except in connection with the advertisement of the general fiduciary services of the bank.

Management Fees. The previous reg allowed a national bank administering a collective investment fund to charge a management fee if the fees charged didn't exceed the total fees that the bank would have charged the fiduciary account if it hadn't invested assets of the account in the collective investment fund.

The new rule allows a national bank to charge a fund management fee only if the fee is reasonable; the fee is expressly permitted under applicable law and the bank complies with disclosure requirements in the state in which the bank maintains the fund; and the amount of the fee doesn't exceed an amount commensurate with the value of legitimate services of tangible benefit to the fiduciary account that wouldn't have been provided to the account if it were not invested in the fund.

Leasing

The OCC published a final rule in the Dec. 18 Fed Register on personal property leasing, giving national banks new authority to acquire personal property for leasing before the bank enters into or arranges a specific leasing transaction, subject to two prudential limits designed to ensure that the acquisition is not speculative.

The amount of personal property a national bank may acquire under this provision is capped at 15% of bank capital and surplus. Also, the acquisition must be consistent with the bank's existing leasing business or with a business plan for its leasing activities.

When a lease expires, a national bank must re-lease or dispose

of the leased property, as soon as practicable, but no later than five years (previously two).

OTS

Subsidiaries

The OTS simplified regulations for savings association subsidiaries Dec. 18, effective Jan. 1.

The rule is a complete overhaul of regulations dealing with setting up, investing in and operating savings associations' subordinate organizations, which are mostly operating subsidiaries and service corporations. The rule features a chart that facilitates easy comparison of the different requirements that apply to subsidiaries and service corporations.

Currently, a thrift's investment in service corporations is limited by law. In the revised rule, OTS clarifies those limits. The parent thrift may hold up to 3% of its assets in stock and loans to a service corporation. It may make additional loans to a service corporation that are of the same type it can make to a third party. Such loans are subject to the same overall statutory investment limits as apply to all loans and to certain additional safeguards specified in the new regs.

The calculation of required capital to be held against investments in subsidiaries is being made less burdensome because the definition of a sub under the capital rule now more closely parallels generally accepted accounting principles and is more consistent with the other banking agencies.

The rule also adds a section dealing with pass-through equity investments. These are investments in entities such as limited partnerships or mutual funds that hold assets or engage exclusively in activities permitted for federal savings associations. Until now, these investments have been discussed only in legal opinions and policy statements. The proposal simplifies certain investment requirements while adding safeguards and grouping them in one place.

The list of preapproved service corporation activities has also been revised. The rule confirms that all activities permitted for federal savings associations, except deposit taking, are preapproved for service corporations. Also preapproved are additional activities that OTS has already routinely approved on a case-by-case basis.

Procedural requirements for thrifts to establish or acquire a new operating subsidiary and to convert an existing service corporation to an operating subsidiary, or the reverse, also have been streamlined.

Internet

The OTS on Dec. 13 announced its home page on the Internet, where users will be able to access information on the agency and the thrift industry it regulates.

It is located at http://www.access-.gpo.gov/ots/.

Users can point and click to get quarterly industry financial data; descriptions of publications offered by OTS and instructions on how to order them; an index of the news releases, legal opinions and other documents available from the OTS PubliFax (fax on demand) service; asset and liability price tables, used by savings institutions to calculate interest rate risk; recent OTS regulations via a link to the Federal Register; and key agency phone numbers.

Federal Reserve

Reserve Requirements

The Fed announced a final rule and notice of proposed rulemaking Dec. 26 designed to simplify and update the Reg D (reserve requirements of depository institutions) and to reduce regulatory burden.

The final rule is effective April 1. Comments are due Feb. 4.

The final rule deletes transitional rules relating to the expansion of reserve requirements to nonmember depository institutions

and the authorization of NOW accounts nationwide. The final rule also eliminates the transition rules for de novo institutions and separate transition rules for "dissimilar" mergers.

The proposed rule requests comments on a clarification of the definition of "savings deposit," and conforming changes to the definition of "transaction account."



**Company Names (DIALOG Generated):** CRA ; Electronic Banking ; Fed Register ; Federal Register ; Fleet Financial ; Integrion Financial Network ; IBM ; Leasing ; NationsBank ; NorWest Corp ; Royal Bank of Canada

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U.S. pension fund investments in real estate: Current and future investment strategy

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**Abstract:**

Real estate is considered a separate asset class. It is also an integral part of the capital markets. In order to attract debt and equity capital, real estate must provide similar risk-adjusted returns as those expected from corporate bonds and equities. No longer is real estate investment made largely on the merits of its diversification characteristics and its supposed inflation hedge. Real estate investment is now made almost exclusively based on risk and return considerations. As the industry evolves and moves beyond the turmoil of the early 1990s, future real estate investment strategy will be devised in light of the relationship between the public and private cost of capital. Values will be determined in a capital markets context. Real estate values will no longer be overly reliant on appraisals, nor will they be viewed simply by their relation to replacement costs. Rather, real estate will be evaluated based on its current cash yield and its potential for growth in income and appreciation as compared to similar risk-adjusted equities in the stock market.

**Text:**

How does the pension plan community currently view the real estate investment market and its advisors? How much capital is being, or will be, allocated to real estate and to what types of investment vehicles? What does the future hold and what is its effect on planning, allocation, and even the continued use of advisors?

These questions, and others, were the motivation behind our analysis of U.S. pension fund investments in real estate. We polled both plan sponsors and real estate advisors and conducted personal interviews with a number of top executives at several of the largest firms in each area.

We found that: Pension fund investment in real estate is indeed quite strong, with most funds projecting to increase the percentage of capital allocated to real estate by as much as 50 over the next five years.

Real estate investment is clearly being treated as more tactical in nature. Plan sponsors as a group are seeking greater liquidity and control over their investments. Plan sponsors are actively diversifying their holdings into the public markets, particularly in the REIT sector.

Investment in private real estate operating companies (REOCs) is receiving a great deal of attention as these investments provide REIT-like characteristics in terms of alignment of incentives (market expertise, management, etc.) albeit without the liquidity and daily market pricing inherent in the public markets.

Plan sponsors expect to decrease the percentage of their real estate capital invested in commingled accounts.

In order to attract capital, real estate must provide similar risk-adjusted returns to those expected from corporate bonds and equities. Though this in not intuitively surprising, professionals within the real estate investment community are no longer promoting the notion that real estate is an inflation hedge or that real estate has little or no correlation with the stock market and therefore has portfolio diversification benefits. While real estate's hedging characteristic may or may not exist, it is not the major consideration it once was when underwriting investment in real estate.

Though the advisory business will continue to manage an increasing amount of capital, it will act as an intermediary for a smaller percentage of the total real estate capital, in part due to both an anticipated decrease of investment in commingled funds and corporate plan sponsors' desire to decrease ownership in direct holdings.

The Survey

Working in cooperation with the Pension Real Estate Association (PREA) and MIT faculty, surveys were sent to 400 plan sponsors and 200 real estate advisory firms. Thirty-nine plan sponsors with a current aggregate real estate portfolio of $30 billion (approximately 5.12 of their total plan assets) and forty-nine real estate advisory firms with a current total of $136 billion under management responded. The plan sponsors returning the survey represented several pension fund types: private (11), public (16), endowment (7), and others (5), and ranged in total asset size from approximately $150 million to well in excess of $50 billion. The $136 billion of assets under management reported by the advisory firms are split approximately in thirds among corporate plans, public plans, and a catch-all category which includes endowments, high-net worth individuals, church plans, etc.

In analyzing the thirty-nine plan sponsor survey responses, the majority had total assets placing them among the largest pension funds in the U.S. Nineteen responding plan sponsors have assets placing them among Pension & Investments' 1995 list of the 100 largest pension funds in the United States. Twenty-eight have assets placing them among the 200 largest pension funds. Because the combined real estate assets of these twenty-eight pension funds represented over 98 of the total real estate assets of all thirty-nine responding plan sponsors, the responses of the smaller eleven pension funds were not included in our survey results. The results presented in this article, therefore, are indicative of only the largest pension funds in the U.S.1

A Look at Current Investment Strategies: Survey Results

Survey Question: How Do Pension Plans View the Real Estate Market: Asset Class or Industry Sector?

This question can have significant ramifications on how they allocate portfolio capital. Viewing real estate as an industry sector (e.g., like

financial services, health care, bio-tech, etc.) may result in lower allocations or investing in real estate only when it is expected to offer higher returns than investments in other industry sectors. The more likely outcome is that real estate is viewed as but one thin slice of a much larger public stock market. The result of this type of strategy may be a greater frequency of transactions, a shorter holding period, and an effort to time markets. At times, real estate may not be part of the portfolio at all.

Conversely, if an investor views real estate as a distinct asset class, it is likely it will play a more constant, and therefore, strategic part in the diversification of the entire portfolio. Based on this investment philosophy, it should be the case that the aggregate investment in real estate is a planned, premeditated percentage of the entire pension plan portfolio, and an allocation target should exist. Although the actual allocation may vary over time, there will always be some minimum commitment to real estate.

As Exhibit 1 shows, 96 of responding plan sponsors viewed real estate as a separate asset class. Further, 85 have an allocation target, currently averaging 8.6 (7.76 on a weighted average basis).

Advisory firms similarly reported that 94 of their clients viewed real estate as a separate asset class. Keeping in mind that all of our responding plan sponsors are among the largest 200 pension plans in the country, it makes sense to consider such a high response as being in favor of real estate as a separate, diversifying asset class (Exhibit 1).2 Survey Question: How Do Pension Plans View Real Estate Investment: Strategic or Tactical? Similar to the distinction of asset class versus industry sector is the question of whether a plan views real estate investments as tactical or strategic. A strategic real estate investor is one that has a minimum percentage of its portfolio always invested in real estate. This investor views real estate as having a strategic role in a mixed-asset portfolio. Strategic investment will be more consistent over time in terms of both minimum allocation targets and holding periods. Implicitly, plan sponsors are willing to "ride out" market cycles. Strategic investment is usually concentrated in core properties and investment vehicles.

Conversely, tactical investment is characterized by more market timing of investments. This in turn would suggest more use of debt, the desire for higher liquidity, and more buy and sell decisions.3

Of the plan sponsors, 35 viewed their real estate as a strategic investment (see Exhibit 2). This result serves to support the arguments of diversification and the historically longer-term investment horizons.

(Graph Omitted)

Captioned as: Exhibit 1

On the other hand, 35 of the plan sponsors viewed real estate investment as a tactical investment. This translates into a desire to engage in some market timing and to seek greater annual returns while taking additional risk. Such strategies might include investing in opportunistic funds or leveraging-up investments in order to augment returns.

The most interesting result observed is that 30 of the responding plan sponsors viewed real estate as both tactical and strategic. This suggests that while real estate may play a long-term strategic role, allocations to real estate will vary over time depending on how real estate's expected returns compare with other asset classes. It would appear, therefore, that real estate investment is becoming more tactical in nature.

While these results may be indicative of a willingness to assume higher risks for higher returns, several of the real estate executives interviewed, who work for plan sponsors, suggested that this really is not the case. Rather, they said, this is simply a result of pension investors trying to take advantage of the current "up cycle" in the real estate markets. It will be interesting to see if these plan sponsors sell in the next down cycle, since this kind of discipline was not evident during past down cycles.

Survey Question: Current versus Targeted Real Estate Allocations

As discussed previously, 96 of plan sponsors viewed real estate as a distinct asset class. It would then follow that almost all responding pension plans would have established real estate allocation targets and have current real estate positions. In fact, most plans do.

A total of 86 of the plan sponsors surveyed have a minimum target allocation -- currently averaging 8.6. While plan sponsor allocation targets vary considerably, they are, on a weighted-average basis, 50 higher than actual funded positions (7.76 versus 5.12, respectively).

Two separate hypotheses may be drawn from this data. First, it can be surmised that there is now an enormous demand for real estate; if the twentyeight funds surveyed were to reach their allocation target, a total of over $14.6 billion in real estate capital would need to be placed in the real estate markets by 2001. This may also translate to a general trend by pension plans to commit a significant additional portion of investment capital to real estate in the coming years.

The second hypothesis suggests that allocation targets are usually higher than actual investment and most plans simply never reach their targets. Over the past five years, high stock market returns have dramatically increased the total portfolio assets of many pension funds. The existing real estate component, meanwhile, has increased in value at a lower rate. The result is the inability of plan sponsors to maintain a real estate allocation target as expressed as a percentage of total plan assets. Allocation targets should therefore be thought of more as a "moving target" than a specific percentage. Survey Question: The Four Quadrants,

How Real Estate Portfolios Have Evolved There is a great deal of talk about constructing real estate portfolios around the concept of the "Four Quadrants" (see Exhibit 3). Under this model, the real estate investment market can be described as four distinct sectors: private equity, private debt, public equity, and public debt.

Traditional investment in real estate has been concentrated primarily in the private debt and equity markets. As more and more real estate assets both properties and mortgages - become securitized in the public markets, however, they are being added to the portfolios of institutional investors. Using the results of our survey of plan sponsors, Exhibits 4 and 5 display the changes of the aggregate real estate portfolio from 1991 to 1996. Exhibit 6 shows the estimated aggregate real estate portfolio in 2001.

(Graph Omitted)

Captioned as: Exhibit 2

(Table Omitted)

Captioned as: Exhibit 3

(Graph Omitted)

Captioned as: Exhibit 4

(Graph Omitted)

Captioned as: Exhibit 5

Private Equity: For the twenty-five years that pension funds have been investing in real estate equities, their investments have been made primarily in the private market, either by purchasing **shares** of commingled funds, private REITs, private limited partnerships, etc., or by acquiring property on a direct basis. Until the early 1990s, there was not a significant public equity real estate securities market option.

The plan sponsors' aggregate portfolio as depicted by our survey reveals that 97 of the total real estate capital in 1991 was invested in private equity of one kind or another. Private equity as a percentage of the aggregate portfolio dropped to 84 in 1996. This is a surprising reduction in view that most of the "give up" was not to public equity (which more than quadrupled to 4 from 1991 to 1996, and yet represents a relatively minor position), but rather to private debt (which increased from 2 to 12). A logical question to ask is, why? The answer can be traced to a few large plan sponsors that dramatically increased their private debt holdings in the last five years. Because debt capital was virtually non-existent in the early 1990s, those pension plans providing debt capital

at this time received returns several hundred basis points over Treasuries.

The percentage of private equity is anticipated to drop further to 73 over the next five years. While much of the give up in this case is predicted to go into public equity, a significant portion is forecasted to once again flow to private debt. The reason for this can again be traced to the few large plans previously discussed. They alone plan to double their private debt allocations for a combined total of several billion dollars.

A total decrease of 24 in the percentage of private equity held in the aggregate real estate portfolio during a ten-year period would seem to represent a major trend away from direct property ownership. The plan sponsors' increasing appetite for liquidity, the significant acquisition, management, and disposition fees associated with direct ownership, and plan sponsors' continued desire for high returns may be the reasons for this dramatic decrease.

Private Debt: Most debt, whole loans, and CMBS are held as part of the pension plan's fixedincome portfolio. For the purposes of this study, the authors analyzed only debt held as part of the real estate portfolio. Traditionally referred to as whole loans, or simply commercial mortgages, private debt increased from 2 in 1991 to 12 in 1996. Further, private debt is anticipated to comprise 14 of the aggregate real estate portfolio in 2001. In the past, real estate debt was almost exclusively held in the fixed-income portfolio. Such a dramatic increase in debt held in the real estate portfolio may represent some kind of new trend. We have not determined the reason for this increase and openly pose the question for future study.

Public Equity: Investment in liquid real estate securities as a percentage of the aggregate portfolio increased from 1 to 4 between 1991 and 1996.

During this same time period, the market capitalization of the public REIT market increased from about $10 billion to approximately $60 billion. Apparently the pension funds surveyed have decided to increase their overall level of real estate liquidity by increasing exposure to public equity REITs. This decision to invest more capital in public REITs could also be return-driven since publicly traded equity real estate securities outperformed the private market by a wide margin during this five-year period.

Plan sponsors project public equity to comprise 11 of their real estate investment capital by 2001. For the twenty-eight plan sponsors surveyed, an 11 allocation to public equity would represent a total investment of $5.68 billion, $4.32 billion more than the current funded position of $1.36 billion. (Our universe of responding plan sponsors consists of twenty-eight funds whose total $30 billion real estate investments represent approximately 20 of the pension fund real estate investment market.) If this 11 REIT allocation figure was extrapolated to all pension fund investment in real estate, an estimated $21 billion in pension plan money alone will be invested in the public equity market over the next five years. Given that the current equity capitalization of the entire REIT market is approximately $80 billion, it may be unlikely that new REIT issues can keep pace with investors' projected demand for ownership in these vehicles.

Public Debt: The capitalization of the public real estate debt market (in the form of commercial mortgage backed securities) totaled $5 billion in 1991. It has increased to approximately $80 billion in 1995. Not a single plan sponsor reported holding public debt in 1991. Further, not a single responding plan sponsor reported holding securitized debt in its current real estate portfolio. According to one executive interviewed at a major advisory firm, the reason lies in the perception that these instruments are complex and confusing in nature. They do not offer satisfactory liquidity due to a lack of an active secondary market.

While such an explanation may have some credence, there is likely more to the story. Plan sponsors hold most of their real estate debt instruments

within their fixed-income portfolios and do not consider these investments as "real estate." It is likely, therefore, that the percentage reported in both public and private real estate debt is understated. Furthermore, "opportunistic" commingled funds sponsored by the advisors often include high-yield, unrated CMBS. It is likely that many pension funds own **shares** in these commingled funds and yet did not report owning CMBS when the surveys were completed.

By the year 2001, plan sponsors anticipated holding 2.4 of their real estate funds in the public debt market. It is important to note, however, that only four respondees anticipate owning public debt. One plan sponsor's allocation alone accounts for much of the predicted increase in public real estate debt.

Survey Question: Targeted Real Estate Returns In polling the plan sponsors for their targeted real estate returns, the authors sought to determine if plan sponsors expected to earn a normal return on real estate investments or whether pension funds are seeking to enhance overall portfolio returns by investing in real estate. This answer should be directly tied to whether plan sponsors view real estate as a tactical or a strategic asset. While several individual plan sponsors seek opportunistic returns in the high teens, the vast majority expect nominal returns between 10 and 12 (11.7 on average). Separated into components, 8.0 is in income and 3.7 is from capital appreciation (Exhibit 7).

(Graph Omitted)

Captioned as: Exhibit 6

An expected return of 11.7 seems to represent an achievable target based on current real estate return data series. The Russell NACREIF Index reported a 1995 total return of 8.93. The NAREIT Index reported a 1995 total return of over 18. With 65 of the plan sponsors viewing real estate investment as tactical, is a 12 return adequate compensation for the risk of trying to time cycles? The yield to maturity on intermediate-term maturity (six to nine years) U.S. government bonds averaged 6.49 in 1995. A 550-basis point spread may well be worth the extra risk.

Survey Question: Leverage

Survey results indicated that 64 of responding plan sponsors are leveraging their real estate investments by an average of 25 (see Exhibit 8).

Asked how the percentage of plan sponsors using leverage will change over the next five years, 29 of the plan sponsors predicted the use of leverage will increase. Only 4 forecasted leverage would decrease, while 29 anticipated no significant change, and 38 were uncertain as to the future use of leverage (Exhibit 9).

The aggregate response of the advisory firms was similar. An estimated 64 of their clients used leverage. Average LTV ratios are 33. Of the advisory firms polled, 31 forecast an increase in the use of leverage. Only 12 predicted a decrease. A total of 56 anticipated no major changes.

Pension plans have historically owned the great majority of their property investments unleveraged. They have ample capital to invest, so using leverage is not required to purchase real estate. Why then is leverage such an integral part of their strategy? The answer is to enhance return-on-investment. Plan sponsors are apparently seeking to capitalize on expected increases in real estate property values. If this is indeed the case, then leveraging would increase in a rising market, and conversely, would decrease when values are in a decline. Given that 67 of the plan sponsors anticipated the use of leverage to increase or remain the same, it may be surmised that the pension funds community anticipates at least a five-year rise in the real estate markets. By attempting to capitalize on this bullish outlook, plan sponsors are inherently treating real estate as a tactical investment.

How Capital is Being Invested and its Effect on the Real Estate Advisory Business

(Graph Omitted)

Captioned as: Exhibit 7

(Graph Omitted)
Captioned as: Exhibit 8
Our focus now turns to the survey responses of the advisory community. The goal here was to determine what sort of effects the changing practices of their clients are having, or will have, on the advisory business. Specifically, the survey attempted to determine the future of investment in commingled funds versus separate or direct accounts. In addition, the survey sought to flush out how much discretion the pension fund community plans to give its real estate advisors.
Survey Question: A Look at Assets Under Management The forty-nine advisory firms included in our survey have a total of $136.6 billion under management. These assets are split approximately in thirds among corporate plans, public plans, and a catch-all category that includes endowments, high-net worth individuals, church plans, etc. A total of $136.6 billion in assets under management represents an increase of 35 since 1991. The responding advisors estimated that by 2001 their assets under management will increase by 60 to $218.4 billion. This predicted increase is not significantly different from the plan sponsors' forecasted 52 growth in total plan assets and their projected 65 increase in its aggregate real estate portfolio (Exhibit 10).
In order to determine the advisors' role in the year 2001, the plan sponsors were asked to predict how the percentage of their real estate capital invested through advisory firms would change by 2001: 37 predicted a net decrease, 11 anticipated an increase, 48 predicted no change, and 4 were not sure. It seems that while total capital invested through advisory firms will increase, a smaller percentage would reflect real estate investments. (See Exhibit 11.) Survey Question: **Discretion**
A topic of keen interest to real estate advisors is the level of **investment discretion** plan sponsors are willing to grant them. In the past, most plan sponsors gave their advisors considerable control over buy and sell decisions. Pension funds that invested in commingled funds gave 100 discretion to the fund manager. Those plan sponsors that invested on a direct basis established varying levels of decision-making responsibility. Clearly, the recent real estate down cycle has resulted in an introspective analysis of where control should ultimately lie and when to limit or expand it. Concerns regarding the misalignment of interests resulting from fee structures tied to buy and hold decisions have become a major topic of debate. With the advent of so many new opportunistic **investment** vehicles, a thorough understanding of who has what **discretion**, and any trends associated with it, can offer valuable insights into the future **investment** practices of the industry.
In discussing **investment discretion**, assets under management fall into two distinct categories: separate or direct accounts, which offer varying degrees of discretion, and commingled funds, which by their structure grant full discretion to its manager.
(Graph Omitted)
Captioned as: Exhibit 9
(Graph Omitted)
Captioned as: Exhibit 10
Separate Accounts: Defined as a real estate portfolio owned by a single pension fund, separate accounts are invariably held by multibillion dollar plan sponsors who have the significant capital resources required to build a properly diversified portfolio for their own account. Of the total separate account capital currently under management by the responding advisory firms, approximately 55 is discretionary; with the public separate account part being 50 discretionary, and the private separate account part being 63.
In polling the advisory community as to the future of discretion over separate accounts, the results given in Exhibit 12 were observed.
Advisor's Response: 58 of the advisors expected the percentage of discretionary public separate account assets to increase, and approximately

39 anticipated a decrease. Asked the same question about private separate account assets, 51 of advisory firms anticipated the percentage to increase, and 41 predicted a decrease. While some disagreement exists about the future of discretion, there appears no discernible difference in the advisors' anticipated changes in public versus private account discretion.

Plan Sponsors' Response: It is interesting to compare the advisors' forecasts for discretion with those of the plan sponsors. Exhibit 13 presents the plan sponsors' view of how discretion will change. Of the public plans surveyed, 33 expected the percentage of separate accounts with full discretion to increase. Only 8 percent predicted a decrease, 42 forecast no major changes, and 17 remained unsure. Not a single private plan expects to increase its percentage of separate accounts with full discretion; 50 predicted a decrease, 33 forecasted no change, and 17 remained unsure.

Clearly, significant disagreement exists on the issue of discretion between the capital providers and the capital intermediaries. The advisory community is unsure whether discretion will either increase or decrease. In contrast, the public plans, with many short on staff and working with limited in-house resources, expected to increase the discretion they give advisors. Only 8 of the public funds anticipated a decrease in discretion given. This is the good news for the advisory community.

(Graph Omitted)

Captioned as: Exhibit 1

(Table Omitted)

Captioned as: Exhibit 12

(Table Omitted)

Captioned as: Exhibit 13

(Graph Omitted)

Captioned as: Exhibit 14

Private plans, however, are not in sync with their public counterparts; 50 anticipated a decrease in the discretion they give advisors. This appears to represent a trend toward consolidating control within the ranks of the plan sponsors and away from advisors.

It may be that some of the disparity between the advisors' expectations and the plan sponsors' predictions can be attributed to limiting the survey responses to only those plan sponsors with assets among the 200 largest pension funds in the U.S. The survey results clearly reflected the bias of these large plans. The aggregate response of the advisors, however, truly may reflect the views of the entire pension real estate investment market, and not just the largest 200 pension funds.

Commingled Accounts

(Table Omitted)

Captioned as: Exhibit 15

Advisors' Response: The responding advisory firms reported that the percentage of assets under management invested in commingled accounts has decreased from 49 in 1991 to 37 in 1996. They further project a decrease to 34 over the next five years. There appears to be a trend away from investment in commingled funds (Exhibit 14).

Plan Sponsors' Response: Plan sponsor responses revealed a weighted-average 26 of the aggregate real estate capital invested in commingled accounts. As a group, 52 of the plan sponsors anticipated this percentage to decrease by 2001; 26 projected an increase, 9 expected no change, and 13 remained uncertain. Some significant differences were observed when comparing responses of the public and private plans. Of the public plans, 36 expected to increase their percentage of real estate capital invested in commingled funds. Not one responding corporate pension plan anticipated increasing its percentage of real estate capital allocated to commingled funds. Almost 45 of the public plans expected to decrease investment in commingled funds; with 65 of the private plan sponsors reporting the same results (Exhibit 15).

In the final analysis, it is not surprising that a significant percentage of the largest pension plans (both public and private), who

typically have the resources and capital to construct their own properly diversified real estate portfolio, expected to decrease the percentage of their real estate capital invested in commingled accounts.

Survey Question: Opportunistic Investment Investors who had the foresight and nerve to invest in real estate in the early 1990s often made attractive returns. The so called "vulture funds" and other types of "bottom fishers" tried to take full advantage of the lack of capital in the market by offering to buy assets at deep discounts. In many ways, these "opportunistic" buyers of real estate changed the way many investors viewed real estate investment. To attract capital, real estate now has to offer returns comparable to those available in venture capital. This approach toward real estate investing is more tactical than strategic, an observation that may partially explain why our earlier survey results indicated that many plan sponsors currently view real estate investment as tactical. To determine if a trend exists in the real estate investor community vis-a-vis "opportunistic investment" (i.e., higher risk, higher return) the advisory community was asked to report what percentage of their assets under management is classified as opportunistic funds (see Exhibit 16).

Survey results indicated that since 1991, the percentage of real estate capital placed in these opportunistic funds has increased by only 2. Real estate capital invested in these vehicles through the forty-nine responding advisory firms currently totals approximately $30 billion, up from $20 billion in 1991. Looking forward five years, advisors predicted a pronounced increase from 22 to 28 of assets under management invested in opportunistic funds. This suggests that total real estate investment capital invested in opportunistic funds by the forty-nine responding advisors will reach $61 billion in the year 2001. A five-year net increase of $31 billion, representing a significant influx of capital into opportunistic real estate vehicles.

Survey Question: Co-Investment with Private Operating Companies

(Graph Omitted)

Captioned as: Exhibit 16

In an effort to solve some of the perceived misalignment of interests that existed between investors and advisory firms related to "direct investment" in real estate, pension funds are apparently open to vehicle structures that dispel some of these conflicts. While there are several types of vehicles offered, one is the concept of a plan sponsor or advisor co-investing alongside a private real estate operating company. It works this way: The operating company puts up its own equity alongside that of the plan sponsor. Both have capital at risk. Both are principals. Acquisition and disposition fees are significantly lower than with traditional advisors, and management fees are replaced with performance fees that are usually "back-ended." The plan sponsor receives a preferred return before the operating company receives its return.

Asked whether they have considered co-investment with private operating companies, 74 answered in the affirmative. Of those that have considered this type of investment, 50 have participated in some kind of co-investment. Our sun/ey results support the hypothesis that co-investing alongside private operating companies is a strategy that is on the rise (Exhibit 17).

Further confirmation of this hypothesis comes from the survey results of the advisory community A significant 74 of responding advisory firms indicated that this form of investment represents a new trend in the industry. Advisory firms will grapple as to how this will impact the future of the traditional real estate advisory business.

Conclusions, Outlook, and Predictions: 1995-1996

Pension Fund Investment in Real Estate At the end of 1995, assets of U.S. pension funds totaled approximately $3.4 trillion, up from $2.5 trillion in 1989.4 U.S. pension funds remain the largest pool of investment capital in the world. Total U.S. non-farm commercial real estate is valued at $3.08 trillion, of which $1.22 trillion is considered to be

"institutional-grade" real estate. Of this $1.22 trillion, approximately 20 is financed with equity and 80 is financed with debt.5 Given that pension funds own approximately 50 of the equity portion, it is not an overstatement to claim that they have a massive controlling influence over the institutional real estate investment arena.

(Graph Omitted)

Captioned as: Exhibit 17

(Graph Omitted)

Captioned as: Exhibit 18

The Stock Market versus Real Estate: 1995-1996 During the past two years, the stock market has continuously reached new highs. U.S. corporate **profits** are strong, and the national unemployment rate stands at approximately 5. The stock market's performance over the last several years has exceeded expectations. Though the stock market has been bullish since 1991, many wonder if a major correction is due. In contrast, a great deal of optimism prevails that the real estate recovery is still young, with plenty of upside left. Real estate returns are strong, yet prices have a long way to climb before reaching replacement costs. The NCREIF Property Index has steadily improved, with 1995 total returns approaching 10. In addition, returns published by The National Association of Real Estate Investment Trusts (NAREIT) have been in double digits for four of the past five years. In 1995, the NAREIT total return was 18.31 (Exhibit 18).

Another difference between real estate and stock investments is that the yields on real estate (for both direct investment and REITs) are significantly higher than those for corporate equities. For the purposes of comparison, it should be stated that the dividend yields on real estate are much greater than corporate equities because many public corporations retain some of their earnings while all of the NOI and most all of FFO on real estate is considered "income yield" (see Exhibit 18).

As the prospects for future increased corporate earnings are incorporated into **share** prices, dividend yields have continued on a long-term downward trend and currently stand at approximately 2. Both plan sponsors and advisors interviewed as part of this study were aware of this trend and stated that the stock market is currently "pricey" and that the yields on real estate are extremely attractive to pension fund investment managers without the speculative reliance on value growth to produce returns (see Cambon [1994]). Several emphatically declared that pension funds will more aggressively fulfill their real estate allocations or increase them altogether.

Survey Conclusions and Interpretations

Asset Class versus Industry Sector. There is nothing monumental to report on this issue. Based on the survey results, for the time being, real estate is awarded separate asset class status.

Strategic versus Tactical Investment. It appears that real estate investment strategy is becoming more tactical in nature.

Leverage. The use of leverage by pension funds has become more prevalent in the last five years. The results of the survey indicate that even more debt may be used in the future. Three interrelated reasons may explain the increase in the use of leverage: 1. Returns for real estate as an asset class must be attractive as compared to alternative risk-adjusted investments in the stock market. 2. It is widely believed that the real estate market is in the midst of an upward cycle. It can, therefore, be argued that leverage is being employed to magnify returns on investments. 3. Pension fund investment strategy is tending to become more tactical; investors are attempting to "time" upswings in the market.

Discretion over Separate Accounts. Increased discretion will likely be granted to advisors managing separate account investments of public plans. Discretion will likely decrease, however, for separate accounts of corporate plans.

As corporations are downsizing and offering employees early retirement, the need for higher levels of plan liquidity does not bode well for increased investment in direct ownership of real estate through

separate accounts.

Commingled Accounts. Investment in commingled accounts will likely decrease for corporate plans. The amount public plans intend to invest in commingled accounts, on the other hand, is unclear. Smaller public plans will likely increase their percentage of real estate capital invested in commingled accounts as they will be unable to invest on a direct basis. Similarly, on the private side, what business there will be for commingled accounts will likely be among the smaller plans.

The real estate advisory firms which manage open-ended commingled accounts consisting of large core portfolios of real estate, diversified by property usage and geographic region (i.e., the life insurance companies), will have to look to smaller pension funds to increase their portfolios, the majority of which will be in the public sector. Opportunistic Investing. Pension funds will continue to allocate capital to opportunistic commingled funds so long as the advisors who manage them continue to deliver high returns. That many of the advisors are sponsoring opportunistic funds may indicate that the advisory community has a tacit mandate from the plan sponsors to deliver high returns.

Investment in Private Operating Companies. Investment in private operating companies is a strong trend which is likely to continue. So long as pension funds are willing to provide debt and equity capital at competitive rates, private operating companies will seek to form alliances. This type of investment, in terms of alignment of incentives, is the next best vehicle to public equity REITs.

Current versus Targeted Real Estate Allocations. Plan sponsors expect to invest multiple billions of dollars in real estate in the coming years. The survey and interviews with industry leaders confirm the general perception that more capital, not less, is headed toward the real estate sector.

The Four Quadrants. Aggregate investment is expected to increase in each of the four quadrants: 1. The percentage invested in direct equity, the mainstay of pension real estate investment, will decrease.

2. The percentage of real estate capital invested in the public markets will dramatically increase. 3. Private debt (whole loans), has increased to approximately 10 of pension plan real estate capital and is forecasted to increase even further during the next five years. 4. Investment in securitized debt is expected to increase.

Targeted Returns. Most pension funds expect a 12 total nominal return on their real estate investments, 8 as income and 4 from capital appreciation.

Closing Remarks

Real estate is considered a separate asset class. It is also an integral part of the capital markets. In order to attract debt and equity capital, real estate must provide similar risk-adjusted returns as those expected from corporate bonds and equities. No longer is real estate investment made largely on the merits of its diversification characteristics and its supposed inflation hedge. Real estate investment is now made almost exclusively based on risk and return considerations.

As the industry evolves and moves beyond the turmoil of the early 1990s, future real estate investment strategy will be devised in light of the relationship between the public and private cost of capital. Values will be determined in a capital markets context. Real estate values will no longer be overly reliant on appraisals, nor will they be viewed simply by their relation to replacement costs. Rather, real estate will be evaluated based on its current cash yield and its potential for growth in income and appreciation as compared to similar risk-adjusted equities in the stock market. The real estate advisory community seems to recognize this, as indicated by their overwhelming survey response predicting that most new pension fund investment will be "opportunistic" in nature. Pension fund investors and the more progressive advisors will continue to employ more tactical strategies. As such, they will seek increased liquidity and follow more fluid investment strategies.

Footnote:

Endnotes

In conducting the surveys, strict confidentiality was promised to responding organizations. Responses are reported in aggregate form only, and no portfolio specific information is offered that could identify an individual pension plan or advisory firm. 2 It also serves their interest.

3 Historically, there were few incentives to ever sell or advise to sell since it might lower allocation of capital and fees.

4 Money Market Directory of Pension Funds and their Advisors. Charlottesville, NC: Money Market Directory 1996.

5 Real Estate Research Corporation and Equitable Real Estate Investment Management, Inc., "Emerging

Footnote:

Trends in Real Estate 1996," October 1995, p. 3. Income figures for the Russell-NACREIF Property Index were taken from the Frank Russell Company's Index Detail, December 31, 1994 and The NCREIF Real Estate Performance Report Fourth Quarter 1995. Dividend figures for NAREIT were taken from 1995 NAREIT Industry Statistics, The National Association of Real Estate Investment Trusts, March 1996, and represent the annualized yield for the month of December of each year. Dividend yields for the S&P 500 Composite represent the annual "close" figures.

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